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Splits and Confounding Issues Destined for the Supreme Court

**Midwest Regional Bankruptcy Seminar
Cincinnati, Ohio
Sept. 27, 2023**

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Supreme Court



Decision (So Far) This Term



The opinion by Justice Barrett largely bases the outcome on the use of the passive voice in Section 523(a)(2)(A).

Debts for a Partner's Fraud Are Still Nondischargeable, the Supreme Court Says

Based on the “natural breadth of the passive voice” used in Section 523(a)(2)(A), the Supreme Court held yesterday in a unanimous opinion by Justice Amy Coney Barrett that a partner who herself was innocent of fraud is nonetheless saddled with a nondischargeable debt resulting from the fraud of her partner.

The opinion is a reaffirmation of the Court’s holding in *Strang v. Bradner*, 114 U.S. 555 (1885).

In a concurring opinion, Justices Sonia Sotomayor and Ketanji Brown Jackson endeavored to limit the scope of the holding by saying that they understood the outcome to be based on the existence of a partnership under state law.

The Partner’s Fraud

Before marrying, a couple formed a partnership to buy, refurbish and sell a home. Judge Barrett said the woman was “largely uninvolved” in the remodel and sale.

Alleging that the disclosure statement failed to list defects in the home, the buyer filed suit after purchasing the home. A jury found the man and woman liable for \$200,000 in damages for breach of contract, negligence and nondisclosure of material facts.

The couple filed a chapter 7 petition. The buyer filed an adversary proceeding contending that the judgment was nondischargeable under Section 523(a)(2)(A) as a debt resulting from “false pretenses, a false representation, or actual fraud.” After a bench trial, the bankruptcy court ruled that the debt was nondischargeable as to both.

The Bankruptcy Appellate Panel for the Ninth Circuit reversed as to the woman, saying she had no reason to know of the man’s fraudulent intent. Relying on *Strang*, the Ninth Circuit reversed the BAP, reinstating the nondischargeability judgment with respect to the woman. According to Justice Barrett, the Court of Appeals reasoned that “a debtor who is liable for her partner’s fraud cannot discharge that debt in bankruptcy, regardless of her own culpability.”



The woman filed a petition for *certiorari*, which the Court granted to resolve a split among the circuits. The Second, Fourth, Seventh and Eighth Circuits require scienter before the debt is deemed nondischargeable, while the Fifth, Sixth, Ninth and Eleventh Circuits don't.

An Opinion Based on Grammar

Judge Barrett held that the “text” of Section 523(a)(2)(A) barred the woman from discharging the debt “[b]y its terms.” Based on the “basic tenets of grammar,” she said that the statute’s use of the “[p]assive voice pulls the actor off the stage.”

Although the debt must result from fraud, Justice Barrett said that “Congress was ‘agnosti[c]’ about who committed it. *Watson v. United States*, 552 U.S. 74, 81 (2007).” The “context” of the statute, she said, “does not single out the wrongdoer as the relevant actor.”

Justice Barrett said that “the common law of fraud . . . has long maintained that fraud liability is not limited to the wrongdoer.” Citing a commentator from 1841 and state supreme court decisions from the nineteenth century, she listed courts that “have traditionally held principals liable for the frauds of their agents.”

The debtor contended that the interpretation of Section 523(a)(2)(A) should be informed by subsections (B) and (C), which require a culpable act by the debtor. Justice Barrett rejected the argument, saying that the “more likely inference is that (A) excludes debtor culpability from consideration given that (B) and (C) expressly hinge on it.”

The Court’s Precedent

“Our precedent,” Justice Barrett said, “eliminates any possible doubt about our textual analysis.”

At the time of *Strang*, the statute required fraud “of the bankrupt.” Nonetheless, the Court held in *Strang* that the “fraud of one partner . . . is the fraud of all because ‘[e]ach partner was the agent and representative of the firm with reference to all business within the scope of the partnership.’” *Strang, supra*, 114 U.S. at 561.

Thirteen years after *Strang*, Justice Barrett said that Congress “overhauled the bankruptcy law,” this time deleting “‘of the bankrupt’ from the discharge exception for fraud, which is the predecessor to the modern § 523(a)(2)(A).”

“The unmistakable implication,” Justice Barrett said, “is that Congress embraced *Strang*’s holding — so we do too.”



Justice Barrett ended her opinion for the Court by saying she was “sensitive to the hardship that the debtor faces,” but she went on to say that “innocent people are sometimes held liable for fraud they did not personally commit, and, if they declare bankruptcy, § 523(a)(2)(A) bars discharge of that debt.”

The Court affirmed the Ninth Circuit’s judgment that the debt was nondischargeable.

The Concurrence

Joined by Justice Jackson, Justice Sotomayor concurred, saying that the “Court correctly holds that 11 U.S.C. § 523(a)(2)(A) bars debtors from discharging a debt obtained by fraud of the debtor’s agent or partner.” Citing *Strang*, she said that the “Court long ago confirmed that reading when it held that fraudulent debts obtained by partners are not dischargeable.”

Justice Sotomayor noted that the woman and her husband incurred the debt after forming a partnership. She said that the “Court here does not confront a situation involving fraud by a person bearing no agency or partnership relationship to the debtor.”

She joined the Court’s opinion with the “understanding” that it concerns fraud only by “agents” and “partners within the scope of the partnership.”

Application to Section 523(a)(19)

Justice Sotomayor’s understanding of the opinion, if adopted by other courts, may affect the application of Section 523(a)(19). That subsection bars the discharge of judgments by state or federal courts for violation of state or federal securities laws, but it too is in the passive voice and does not in its language demand a violation committed by the debtor.

Presumably, a court influenced by Justice Sotomayor’s concurrence would make a debt nondischargeable as to an innocent debtor only if there were an agency or partnership.

Observations

Justice Barrett rejected the debtor’s reliance on *Bullock v. BankChampaign, N. A.*, 569 U.S. 267 (2013). There, the Court held that under Section 523(a)(4) the term “defalcation”

includes a culpable state of mind requirement akin to that which accompanies application of the other terms in the same statutory phrase. We describe that state of mind as one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior.

Id. at 269.



Bullock means that defalcation cannot be derivative, but the Court yesterday held that a fraudulent representation or actual fraud can be derivative.

Curiously, *Strang* cited and discussed *Neal v. Clark*, 95 U.S. 709 (1877). The *Strang* court paraphrased *Neal* as saying that

the term “fraud,” in the clause defining the debts from which a bankrupt is not relieved by a discharge under the bankrupt act, should be construed to mean positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, and not implied fraud or fraud in law, which may exist without the imputation of bad faith or immorality.

Neal required “positive fraud, or fraud in fact,” but the Court yesterday imposed nondischargeability when the debt was derived from someone else’s fraud.

With respect, this writer sees the Court as being selective in citing nineteenth century precedent for the idea that innocent individuals can be saddled with nondischargeable debts.

True, common law for centuries has held that one partner is liable for another partner’s fraud, but nondischargeability and derivative liability for fraud are different questions under a different statute.

However, Congress adopted Section 523(a)(2)(A), presumably knowing what *Strang* says. Still, this writer is troubled by the notion that contemporary courts are so bound by nineteenth century precedent.

[The opinion is](#) *Bartenwerfer v. Buckley*, 143 S. Ct. 665, 214 L. Ed. 2d 434 (Sup. Ct. Feb. 22, 2023).



The Supreme Court's MOAC decision contains language casting doubt on the validity of the doctrine of equitable mootness.

Supreme Court Holds: § 363(m) Isn't Jurisdictional; It's a Limitation on Appellate Relief

Reversing the Second Circuit, the Supreme Court handed down a unanimous opinion today in *MOAC Mall Holdings LLC*, deciding that Section 363(m) is not jurisdictional. It's a limitation on the remedy available to an appellate court on an appeal from an order approving a sale.

Section 363(m) says that the reversal or modification “of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease [to a purchaser in good faith] . . . unless such authorization and such sale or lease were stayed pending appeal.”

The Second and Fifth Circuits have held that Section 363(m) is jurisdictional. The Third, Sixth, Seventh, Ninth, Tenth and Eleventh Circuits have held that it is not. The opinion for the Court by Justice Ketanji Brown Jackson was her first since her elevation in June 2022.

The Sale of a Sears Lease

The petitioner in the Supreme Court was the landlord of a Sears store in the giant Mall of America. The landlord objected to the assignment of a lease but lost in bankruptcy court.

Initially, the district court reversed the bankruptcy court, holding that a provision in a lease cannot supplant the requirement in Section 365(b)(3)(A) mandating that the financial condition of an assignee of a lease must be “similar to the financial condition . . . of the debtor . . . as of the time the debtor became the lessee under the lease . . .” *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 613 B.R. 51 (S.D.N.Y. May 11, 2020). (“*MOAC I*”). To read ABI's report on *MOAC I*, [click here](#).

Two weeks later, the purchaser of the lease filed a motion for rehearing. Although having taken contrary positions throughout, the purchaser contended for the first time on rehearing that the appeal should be dismissed under Section 363(m) because the landlord had not obtained a stay pending appeal. Previously, the purchaser had consistently contended that the transaction was not a sale and that Section 363 did not apply.



Ruling on the motion for rehearing, the district judge said that the buyer now “seeks to benefit from a complete reversal of that representation.” *MOAC II*, 616 B.R. at 626. Citing *In re WestPoint Stevens Inc.*, 600 F.3d 231, 248 (2d Cir. 2010), and *In re Gucci*, 105 F.3d 837, 838–840 (2d Cir. 1997), the district judge said that the Second Circuit had twice held that Section 363(m) is “a jurisdiction-depriving statute.” *Id.* at 624.

In *MOAC II*, the district judge granted rehearing, concluded that she lacked appellate jurisdiction, vacated her earlier opinion, and dismissed the appeal. The Second Circuit affirmed in a nonprecedential opinion. *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 20-1846, 2021 BL 481940, 2021 US App Lexis 37358, 2021 WL 5986997 (2d Cir. Dec. 17, 2021). To read ABI’s report on the Second Circuit opinion, [click here](#).

The circuit panel said that the landlord’s argument “is foreclosed by our binding precedent in *In re WestPoint Stevens Inc.*, under which § 363(m) deprived the District Court of appellate jurisdiction.” In another nonprecedential opinion citing *WestPoint Stevens*, a Second Circuit panel indeed had said that Section 363(m) is jurisdictional because it “creates a rule of statutory mootness.” *Pursuit Holdings (NY) LLC v. Piazza (In re Pursuit Holdings (NY) LLC)*, 845 Fed. App’x 60, 62 (2d Cir. 2021).

The landlord filed a petition for *certiorari* in March 2022, raising the circuit split. The Court granted the petition at the end of the last term in June 2022.

Jurisdiction Must Be ‘Clearly Stated’

Addressing the merits, Justice Jackson rejected the buyer’s “creative arguments” and mirrored comments from the district court when she referred to the buyer’s conduct as “egregious” in waiting until rehearing in district court to raise the question of jurisdiction.

Justice Jackson’s opinion is another stab at repairing the Court’s precedents on jurisdiction versus power. She referred to “our past sometimes loose use of the word ‘jurisdiction.’” More recently, she said, “We have clarified that jurisdictional rules pertain to ‘the power of the court rather than to the rights or obligations of the parties.’”

Today, Justice Jackson said, “we only treat a provision as jurisdictional if Congress ‘clearly states’ as much,” citing *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493, 1494 (2022). On the other hand, Congress isn’t required to use “magic words,” she said.

To be jurisdictional, Justice Jackson said that “the statement must indeed be clear; it is insufficient that a jurisdictional reading is ‘plausible,’ or even ‘better,’ than nonjurisdictional alternatives,” again citing *Boechler*.



Applying precedent, Justice Jackson saw “nothing” in Section 363(m) “that purports to ‘gover[n] a court’s adjudicatory capacity,’” quoting *Henderson v. Shinseki*, 562 U.S. 428, 435 (2011). To the contrary, she said that “§ 363(m) takes as a given the exercise of judicial power over any authorization under § 363(b) or § 363(c).”

The section, Justice Jackson said, “consists of a caveated constraint on the effect of a reversal or modification” and “is not the stuff of which clear statements are made.”

Noting that Section 363(m) is not located in 28 U.S.C. § 1334(a)-(b), (e) and § 157, Justice Jackson said, “Statutory context leads to the same conclusion” that Section 363(m) is not jurisdictional. She said that the buyer “does not (because it cannot) deny the paucity of textual or contextual clues indicating a clear statement of jurisdictional intent.”

Justice Jackson said that Section 363(m) is “a mere restriction on the effects of a valid exercise of [appellate] power when a party successfully appeals a covered authorization.”

Commentary on Equitable Mootness?

The buyer argued in the Supreme Court that the appeal was moot even without regard to Section 363(m). Justice Jackson rejected the argument using words that might be read as undercutting the validity of the doctrine of equitable mootness, which is the topic of a pending petition for *certiorari*. See *U.S. Bank N.A. v. Windstream Holdings Inc.*, 22-926 (Sup. Ct.).

Without relying on Section 363(m), the buyer argued that the appeal was moot because the transfer of the lease could not now be avoided as a post-petition transaction under Section 549 since the debtor alone had standing to raise Section 549 and the debtor had waived any rights under that section.

In short, the buyer was saying that the appeal was moot because no relief could be granted.

Justice Jackson said that a “‘case becomes moot only when it is impossible for a court to grant any effectual relief whatever to the prevailing party,’” quoting *Chafin v. Chafin*, 568 U.S. 165, 172 (2013). “The case remains live,” she said, “[a]s long as the parties have a concrete interest, however small, in the outcome of the litigation.” *Id.*

In the MOAC appeal, Justice Jackson said, “[W]e cannot say that the parties have ‘no ‘concrete interest,’” *id.* at 176, in whether [the buyer] obtains that relief.”

As a court of “first review,” Justice Jackson rejected the mootness contention, saying, “[W]e decline to act as a court of ‘first view,’ plumbing the Code’s complex depths in ‘the first instance’ to assure ourselves that [the buyer] is correct about its contention that no relief remains legally available.”



The Court remanded the case to the Second Circuit for “further proceedings consistent with this opinion.”

Observations

Today’s opinion casts doubt on the doctrine of equitable mootness, where courts routinely dismiss appeals from confirmation orders where the plans have been consummated. *MOAC* could be read to mean that appellate courts should not in the first instance decide that no relief is available following reversal.

MOAC could be read to mean that an appellate court should hear an appeal from a confirmed plan as long as there is constitutional or Article III jurisdiction. More often than not, the appellate court will uphold confirmation and never reach the question of whether there would have been available relief had there been a reversal.

On remand from reversal of confirmation, the bankruptcy court might locate a sliver of relief for the appellant that would not upset the apple cart and undo the plan altogether. Perhaps the bankruptcy court could award attorneys’ fees to the creditor who appealed confirmation and established an important principle about chapter 11 plans.

[The opinion is](#) *MOAC Mall Holdings LLC v. Transform Holdco LLC*, 22-1270 (Sup. Ct. April 19, 2023).



The high court's ruling on the Takings Clause also seems to mean that real estate tax foreclosures can be avoided as constructively fraudulent transfers.

Supreme Court Holds that Real Estate Tax Foreclosures Can Violate the Takings Clause

Barely one month after oral argument, the Supreme Court unanimously resolved a split of circuits by reversing the Eighth Circuit and holding that a real estate tax foreclosure can violate the Takings Clause of the Fifth Amendment when the municipality takes title but doesn't give the owner the difference between the unpaid taxes and the value of the property.

For the Court, the opinion by Chief Justice John G. Roberts, Jr. said that “[h]istory and precedent” do not permit the state to take away a property interest protected by the Takings Clause.

\$40,000 Property Taken for \$15,000 in Taxes

A 94-year-old woman had owned a condominium. She went to live in a senior community but did not continue paying real estate taxes on the condominium. When some \$2,300 in unpaid real estate taxes accrued along with \$13,000 in interest and penalties, the municipality seized the property and sold it for \$40,000. The county kept the \$25,000 surplus and paid none to the former homeowner.

Conceding the validity of the foreclosure, the homeowner filed a class action under the Takings Clause, challenging the county's retention of the \$25,000 surplus. The district court dismissed the suit for failure to state a claim and was affirmed last year in the Eighth Circuit. *Tyler v. Hennepin County*, 26 F.4th 789 (8th Cir. 2022).

The appeals court found no unconstitutional taking because state law recognized no property interest in the owner after the property was seized. The homeowner filed a petition for *certiorari* in May 2022.

While the *certiorari* petition was pending, the Sixth Circuit created a circuit split by holding that a real estate tax foreclosure violated the Takings Clause. *Hall v. Meisner*, 51 F.4th 185 (6th Cir. Oct. 13, 2022). The municipality in *Hall* had taken a \$300,000 home in satisfaction of \$22,250 in real estate taxes but refused to turn over the surplus. The Sixth Circuit denied a motion for rehearing *en banc* in January. To read ABI's report on *Hall*, [click here](#).



The Supreme Court granted *certiorari* in January and held oral argument on April 26. To read ABI's report on argument, [click here](#).

History and Precedent Rule the Day

The Chief Justice recited the history of real estate tax foreclosure in Minnesota. "Historically," he said, the state recognized an owner's property interest in the excess value in a home sold to satisfy delinquent property taxes. In 1935, he said that "the State purported to extinguish that property interest by enacting a law providing that an owner forfeits her interest in her home when she falls behind on her property taxes."

Against the backdrop of state law, the Chief Justice explored precedent regarding the Takings Clause. Contained in the Fifth Amendment, the clause provides that "private property [shall not] be taken for public use, without just compensation."

The Chief Justice noted that the clause itself "does not define property." He stated the question as "whether that remaining value is property under the Takings Clause, protected from uncompensated appropriation by the State."

The Chief Justice said that state law "is one important source" for defining property rights "but cannot be the only source." Otherwise, he said, the state could "sidestep" the Takings Clause by disavowing traditional property interests. He therefore looked at traditional property law principles "plus historical practice and this Court's precedents."

History

For the "principle that a government may not take more from a taxpayer than she owes," the Chief Justice went back to "Runnymede in 1215" and found that the principle "became rooted in English law" by acts of Parliament and common law. Then, he said, the principle "made its way across the Atlantic."

Today, the Chief Justice said that the county identified only three states that deem property "entirely forfeited" for delinquent taxes. In contrast, he said that 36 states and the federal government "require that the excess value be returned to the taxpayer."

High Court Precedent

Citing decisions by the Court in 1881 and 1884, the Chief Justice said that "[o]ur precedents have also recognized the principle that a taxpayer is entitled to the surplus in excess of the debt owed." The county, in response, relied on *Nelson v. City of New York*, 352 U.S. 103 (1956), where the Court upheld the foreclosure of property for unpaid water bills.



The Chief Justice distinguished *Nelson* by noting how the taxpayer had waived a statutory right to recover the surplus. There was no Takings Clause violation, because the city had not absolutely precluded the owner from recovering the surplus.

The Chief Justice said that Minnesota “itself recognizes that in other contexts a property owner is entitled to the surplus in excess of her debt.” For example, he mentioned real estate mortgage foreclosures, where a homeowner is entitled to the surplus after foreclosure.

The Chief Justice reversed the Eighth Circuit, saying that the homeowner “has plausibly alleged a taking under the Fifth Amendment,” because the state made “an exception only for itself, and only for taxes on real property.” Minnesota, he said, “may not extinguish a property interest that it recognizes everywhere else to avoid paying just compensation when it is the one doing the taking.”

The Concurring Opinion

Agreeing there was a “plausibly alleged” violation of the Takings Clause, Justice Neil M. Gorsuch wrote a concurring opinion, joined by Justice Ketanji Brown Jackson. They wrote separately to deal with the Excessive Fines Clause in the Eighth Amendment.

In addition to the Takings Clause, the Eighth Circuit had found no violation of the Excessive Fines Clause. The Chief Justice did not address the Eighth Amendment, because the homeowner said that the finding of a Takings Clause violation would fully remedy her harm.

Justices Gorsuch and Jackson concurred because, they said, “even a cursory review” of the circuit’s decision “reveals that it too contains mistakes future lower courts should not be quick to emulate.”

The Eighth Circuit saw no Eighth Amendment violation, because they believed the statute to be remedial. Justice Gorsuch said, “It matters not whether the scheme has a remedial purpose, even a predominantly remedial purpose.” The Excessive Fines Clause does not apply only when the statute is solely remedial.

According to Justice Gorsuch, the district also found no Eighth Amendment violation because the statute was not punitive, since it did not turn on culpability. He said that a statute may still be punitive if it uses punishment as a deterrent.

Justice Gorsuch ended his concurrence by saying:

Economic penalties imposed to deter willful noncompliance with the law are fines by any other name. And the Constitution has something to say about them: They cannot be excessive.



Observations

The finding of a constitutional right to the surplus in a tax foreclosure may put a related issue to rest: Can a tax foreclosure be attacked in bankruptcy as a fraudulent transfer?

In *BFP v. Resolution Trust*, 511 U.S. 531 (1994), the Supreme Court held that regularly conducted real estate mortgage foreclosures cannot be fraudulent transfers, no matter how much equity the debtor loses above the mortgage debt.

The Fifth, Ninth and Tenth Circuits expanded *BFP* by holding that real estate tax foreclosures cannot be avoided as fraudulent transfers. The most recent of those decisions came from the Ninth Circuit. See *Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI's report on *Tracht Gut*, [click here](#).

The Second, Third, Sixth and Seventh Circuits have held that real estate tax foreclosures can be attacked as fraudulent transfers. To read ABI's reports, [click here](#), [here](#), [here](#) and [here](#).

Since a tax foreclosure can violate the Constitution, it stands to reason that a tax foreclosure can be avoided as a fraudulent transfer.

Granted, the standards for finding a constitutional violation and a constructively fraudulent transfer are different. Given that courts will not rule on constitutional questions when the same result can be reached by other means, this writer believes that courts in the future will examine real estate tax foreclosures to find fraudulent transfers before turning to the Constitution.

This writer bases his belief on the holding by the Chief Justice that a homeowner has a constitutionally protected property interest in the surplus arising from a tax foreclosure.

Indeed, one could ask whether *BFP* can be reconciled with *Tyler*. If the surplus in foreclosure is constitutionally protected property, how can a real estate tax foreclosure pass muster no matter how much equity the owner loses in foreclosure?

[The opinion is](#) *Tyler v. Hennepin County*, 22-166 (Sup. Ct. May 25, 2023).



The Supreme Court resolved a split of circuits in an opinion that could give support to the notion that arbitration agreements are not enforceable in bankruptcy.

Supreme Court: The Bankruptcy Code Waived Tribes' Sovereign Immunity

Over a dissent by Justice Neil M. Gorsuch, Justice Ketanji Brown Jackson held for herself and six other justices that Section 106(a) of the Bankruptcy Code waives sovereign immunity as to tribes of Native Americans.

Justice Clarence Thomas concurred in the judgment, believing that tribes never had sovereign immunity to begin with.

Compelling Facts for the Debtor

The debtor borrowed \$1,100 from a corporate payday lender before filing bankruptcy. The lender was owned by a federally recognized tribe. By the time the debtor filed a chapter 13 petition, the debt had grown to almost \$1,600 as an unsecured, nonpriority claim.

Despite the automatic stay and despite being told about the bankruptcy, the tribal lender continually called the debtor demanding payment. Two months after bankruptcy, the debtor attempted suicide, blaming his action on the incessant calls.

In bankruptcy court, the debtor sought an injunction to halt collections attempts, along with damages and attorneys' fees. The bankruptcy court granted the tribe's motion to dismiss, based on sovereign immunity. The First Circuit accepted a direct appeal and reversed over a vigorous dissent.

For the majority, First Circuit Judge Sandra L. Lynch took sides with the Ninth Circuit, which had held in 2004 that Section 106(a) abrogated sovereign immunity for tribes. *Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055, 1061 (9th Cir. 2004). She disagreed with the Sixth Circuit, which found no waiver in 2019. *In re Greektown Holdings, LLC*, 917 F.3d 451, 460- 61 (6th Cir. 2019), *cert. dismissed sub nom. Buchwald Cap. Advisors LLC v. Sault Ste. Marie Tribe*, 140 S. Ct. 2638 (2020). While the *certiorari* petition was pending in *Greektown*, the case settled, and the petition was dismissed. To read ABI's report on *Greektown*, [click here](#).



The debtor in the First Circuit filed a petition for *certiorari*, which the Court granted in September. Oral argument was held in January. To read ABI's report on argument, [click here](#).

The Majority's Rationale

Justice Jackson began her June 15 opinion by laying out the law on waivers of sovereign immunity. Congressional intent to waive immunity must be made in "unequivocal terms." Although the Court does not oblige Congress to use "magic words," the intent to waive must be "unmistakably clear" or "clearly discernable" from the statute.

The circuits were split because the statute arguably leaves something to be desired. For "governmental units," Section 106(a) waives sovereign immunity as to a long list of sections in the Bankruptcy Code. The Section 362 automatic stay is on the list.

Section 101(27) defines "governmental unit." Regarding waiver as to tribes, the question for the Supreme Court was whether tribes come under the rubric of "other foreign or domestic government," as used in Section 101(27).

Justice Jackson did not leave the reader in doubt. After laying out general law, she said:

[T]he Bankruptcy Code unequivocally abrogates the sovereign immunity of any and every government that possesses the power to assert such immunity. Federally recognized tribes undeniably fit that description; therefore, the Code's abrogation provision plainly applies to them as well.

To justify the conclusion, Justice Jackson wrote a 16-page opinion, one page shorter than the dissent. She said that the statutory "definition of 'governmental unit' exudes comprehensiveness from beginning to end." By "coupling foreign and domestic together, and placing the pair at the end of an extensive list, Congress unmistakably intended to cover all governments in §101(27)'s definition, whatever their location, nature, or type," she said.

Justice Jackson found reinforcement in other aspects of the Bankruptcy Code, such as the application of the Code's "requirements generally . . . to all creditors. "

Finding no "indication" that Congress "categorically" excluded "certain governments" from the Code's "enforcement mechanisms and exceptions," Judge Jackson identified the "one remaining question" as whether federally recognized tribes "qualify as governments."

Justice Jackson said that Congress "repeatedly characterizes tribes as governments." Given that the "Code unequivocally abrogates the sovereign immunity of all governments, categorically," and that "Tribes are indisputably governments," she held that "§106(a) unmistakably abrogates their sovereign immunity too."



The Tribe's Arguments Rejected

Justice Jackson devoted the final six pages of her opinion to rebutting the tribe's arguments, such as the fact that every other case finding a waiver involved a statute that specifically mentioned tribes.

Justice Jackson said that "the universe of cases . . . is exceedingly slim," and the fact that Congress had mentioned tribes specifically "does not foreclose it from using different language to accomplish that same goal in other statutory contexts."

Justice Jackson addressed the dissent by Justice Gorsuch, who described tribes as a "hybrid" that is neither "foreign" nor "domestic." She found it "hard to see why the Code would subject purely foreign or domestic governments to enforcement proceedings while at the same time immunizing government creditors that have both foreign and domestic attributes."

Finally, Justice Jackson said that the definition of "governmental unit" is "undeniably broader" in the Bankruptcy Code than it was under the former Bankruptcy Act. "[H]owever Congress may have treated governmental entities in bankruptcy law prior to 1978," she said, "it had clearly altered its view about the scope of coverage relative to governments by the time it enacted §101(27) and §106(a)."

Justice Jackson affirmed the First Circuit.

The Concurrence

Justice Thomas concurred in the judgment, but on entirely different grounds. He said that "the Court should simply abandon its judicially created tribal sovereign immunity doctrine."

Citing his own dissent in a prior case, Justice Thomas said that tribal sovereign immunity was not mandated by the Constitution but was a common law doctrine. "Because no federal law accords tribes sovereign immunity in federal court," he said, the tribe "lack[s] immunity in this federal case."

Furthermore, Justice Thomas said that governments protected by sovereign immunity have no protection for their "commercial acts."

"Accordingly," Justice Thomas said, "any common-law immunity that [the tribe] possess[es] cannot support [its] claim to immunity in federal court for their off-reservation commercial conduct."

The Dissent by Justice Gorsuch



Justice Gorsuch opened his 17-page dissent by saying that tribes were specifically mentioned in the statute every time the Court has previously found a waiver of sovereign immunity. Although the majority’s interpretation was “plausible,” he said that “plausible is not the standard our tribal immunity jurisprudence demands.”

From “two centuries of history and precedent,” Justice Gorsuch said, “Tribes [have enjoyed] a unique status in our law,” meaning that they are neither “foreign” nor “domestic.” Because the Bankruptcy Code does not refer to tribes specifically, he found no waiver.

Justice Gorsuch addressed the majority’s notion that the Bankruptcy Code “exudes comprehensiveness.” He said it’s “true but not obviously helpful,” because the Court has never “held that a statute’s general atmospherics can satisfy the clear-statement rule when the text itself comes up short.”

Quoting his own concurrence in a case last term, Justice Gorsuch “respectfully” dissented because Congress cannot use “oblique or elliptical language.”

Observations

Policy arguments typically gain little or no traction in textualist decisions by the Supreme Court.

It is therefore noteworthy that Justice Jackson found support for her conclusion in “[o]ther aspects of the Bankruptcy Code” and “the Code’s ‘orderly and centralized’ debt-resolution process,” which, she said, “generally apply to *all* creditors.” [Emphasis in original.]

At least when it comes to decisions involving the Bankruptcy Code, the Supreme Court might be amenable to interpreting a confusing provision in light of the larger principles undergirding the Code.

If a case one day asks the Supreme Court to decide whether arbitration agreements are enforceable in bankruptcy, the statement by Justice Jackson that the Code’s provisions “generally apply to *all* creditors” suggests that arbitration agreements are unenforceable in bankruptcy, given the Code’s “orderly and centralized” processes.

[The opinion is](#) *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin*, 22-227 (Sup. Ct. June 15, 2023).



Split 5/4, the Supreme Court rules that denial of a motion to compel arbitration automatically imposes a stay pending appeal.

A Supreme Court Arbitration Opinion Could Disrupt Bankruptcies

A 5/4 arbitration decision by the Supreme Court on June 23 in a nonbankruptcy case could disrupt bankruptcies large and small.

In *Coinbase Inc. v. Bielski*, the Supreme Court held that denial of a motion to compel arbitration automatically imposes a stay on the entire action in the trial court, pending appeal from the order denying arbitration.

If *Coinbase* applies in bankruptcy cases, the bankruptcy court would at a minimum be automatically enjoined from deciding issues involving a creditor that unsuccessfully called for arbitration.

The four dissenters in the Supreme Court likened the majority's opinion to opening "Pandora's box." Disruption of bankruptcy cases may be one of the unintended, unanticipated effects to emerge from *Coinbase*. Application of *Coinbase Inc.* to chapter 11 cases may impel the Supreme Court to decide whether or not arbitration clauses are generally unenforceable in bankruptcy cases.

The Facts and the Circuit Split

A customer filed a putative class action in federal district court against an online platform for buying and selling cryptocurrencies. The complaint alleged that the platform failed to replace funds taken fraudulently from accounts.

The platform filed a motion to compel arbitration, based on an arbitration clause contained in the user agreement. The district court denied the arbitration motion.

Citing 9 U.S.C. § 16(a), the platform filed an interlocutory appeal. As Justice Brett M. Kavanaugh said in his majority opinion for the Court, "Section 16(a) authorizes an interlocutory appeal from the denial of a motion to compel arbitration."

The platform moved in district court for a stay pending appeal. The district court denied the stay, as did the Ninth Circuit. To resolve a split of circuits on whether stays pending appeal are



automatic following denial of an arbitration motion, the Supreme Court granted *certiorari* and heard argument on March 21.

The Majority Opinion

Justice Kavanaugh said that Section 16(a) contains “a rare statutory exception to the usual rule” that appeals are not taken from interlocutory orders. He also said that the section “does not say whether the district court proceedings must be stayed.”

Finding an automatic stay, Justice Kavanaugh based his conclusion on a statement in *Griggs v. Provident Consumer Discount Co.*, 459 U.S. 56, 58 (1982), that an appeal “divests the district court of its control over those aspects of the case involved in the appeal.”

Justice Kavanaugh reasoned that “the entire case is essentially ‘involved in the appeal,’” citing *Griggs, id.* Citing the Seventh Circuit, he said that whether the case may go ahead in district court is precisely the issue on appeal. Also citing the Seventh Circuit, he said it makes no sense to proceed in district court while the appeals court decides whether there should be a case in district court at all.

“In short,” Justice Kavanaugh said, “*Griggs* dictates that the district court must stay its proceedings while the interlocutory appeal on arbitrability is ongoing.” Saying that most courts impose a stay automatically, he said that “common practice makes common sense.”

Dismissing five arguments advanced by the plaintiff, Justice Kavanaugh said that the benefits of arbitration could be “irretrievably lost” were the action to proceed in the trial court pending appeal.

The Dissenters

Justice Ketanji Brown Jackson dissented, joined by Justices Sonia Sotomayor and Elena Kagan. Justice Clarence Thomas joined in most of Justice Jackson’s dissent.

Justice Jackson said that the majority “departs from the traditional approach” by imposing “a mandatory stay of trial court proceedings.” The mandatory stay rule, she said, “comes out of nowhere” and “perpetually favor[s] one class of litigants.”

Justice Jackson saw no mandatory stay rule in Section 16(a). Indeed, she said that the section “never even mentions a stay pending appeal.”

Rather than justifying an automatic stay, Justice Jackson said that *Griggs* “expresses a far narrower principle” that two courts “should avoid exercising control over the same order or judgment simultaneously.” To her way of thinking, “*Griggs* divests the district court of control over



only a narrow slice of the case,” namely, the ability to modify the order refusing to compel arbitration.

On appeals, Justice Jackson said that only arbitrability was before the appellate court, “not the merits.”

Justice Jackson began the last two pages of her 15-page opinion by saying that the majority “ventures down an uncharted path — and that way lies madness.” She said that a “wide array of appeals seemingly fits the bill.”

An “appeal over the proper forum for a dispute” or “all appeals over forum-selection agreements” would “arguably raise the same question,” just like orders granting preliminary injunctions, Justice Jackson said. “Taken that broadly,” she warned, “the mandatory-general-stay rule the Court adopts today would upend federal litigation as we know it.”

Justice Jackson ended her dissent by saying that the “mandatory-general-stay rule that the Court manufactures is unmoored from Congress’s commands and this Court’s precedent.”

Observations

The Supreme Court has yet to decide where or to what extent arbitration clauses are enforceable in bankruptcy. Is arbitration always prohibited, or only when the dispute falls within the bankruptcy court’s “core” jurisdiction?

The majority opinion does not limit the automatic stay rule to particular sorts of cases. Presumably, it also applies in bankruptcy.

Suppose a creditor’s agreement with the debtor contains a broadly worded arbitration clause. What if the debtor objects to the creditor’s claim, the creditor invokes the arbitration agreement, and the bankruptcy court denies the motion to compel arbitration? Is the objection to claim automatically stayed pending appeal to the district court, the circuit court and the Supreme Court?

Or, what about the question of whether a creditor with an arbitration agreement is impaired by a chapter 11 plan? Or, what if the creditor claims that the plan is not fair and equitable? Are the proceedings in bankruptcy court automatically enjoined until there is a final order declining to compel arbitration?

Compelling arbitration in bankruptcy cases could stall chapter 11 cases. Depending on the nature of the issue, a *Coinbase* automatic stay pending appeal could delay, disrupt or torpedo a reorganization.

[The opinion is](#) *Coinbase Inc. v. Bielski*, 22-105 (Sup. Ct. June 23, 2023).



The Supreme Court ducked the question of whether Puerto Rico and other U.S. territories are entitled to Eleventh Amendment sovereign immunity just like states.

Supreme Court Holds that PROMESA Didn't Waive Puerto Rico's Sovereign Immunity

Over a dissent by Justice Clarence Thomas, the Supreme Court *assumed* that Puerto Rico and the Financial Oversight and Management Board are entitled to sovereign immunity like a state. In her opinion of the Court on May 11, Justice Elena Kagan reversed the First Circuit by holding that nothing in the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), waived the Oversight Board's sovereign immunity.

The Origins of PROMESA and the Board

After the Supreme Court ruled that Puerto Rico was ineligible for municipal bankruptcy in chapter 9 of the Bankruptcy Code, Congress quickly enacted PROMESA, which adopts large portions of chapter 9. Puerto Rico and many of its instrumentalities sought relief under PROMESA in 2017 in what is known as Title III debt-adjustment proceedings.

In the Title III proceedings, Puerto Rico's federally appointed Financial Oversight and Management Board in substance represented Puerto Rico and its instrumentalities. In April 2022, the First Circuit upheld confirmation of the Oversight Board's plan of adjustment for the Commonwealth of Puerto Rico. To read ABI's report, [click here](#).

In 2017 and again in 2019, nonprofit media organizations filed suit in federal district court in Puerto Rico, asking the PROMESA court to compel the Oversight Board to disclose broad categories of information and communications regarding the proceedings. The Board filed a motion to dismiss based on Eleventh Amendment sovereign immunity, among other things.

The district court denied the motion to dismiss and ordered the production of documents and other information. The district court reasoned that the Board was entitled to sovereign immunity but that Section 106 of PROMESA had waived and abrogated immunity.

The Board appealed.

First Circuit Finds a Waiver of Immunity



The First Circuit had previously held that Puerto Rico and the Oversight Board were entitled to sovereign immunity. Therefore, the First Circuit only considered on appeal whether PROMESA had waived sovereign immunity as to the suit by the news organization.

Finding a waiver of sovereign immunity, the majority on the First Circuit panel principally relied on Section 106 of PROMESA, which says that “any action against the . . . Board, [or] . . . otherwise arising out of [PROMESA] . . . shall be brought in [the district court for the district of Puerto Rico].” 48 U.S.C. § 2126(a).

By the inclusion of Section 106, the First Circuit majority reasoned that “Congress unequivocally stated its intention that the Board could be sued for ‘any action . . . arising out of [PROMESA],’ but only in federal court. Congress was unmistakably clear that it had contemplated remedies for constitutional violations and that injunctive or declaratory relief against the Board may be granted.” *Financial Oversight & Management Board for Puerto Rico v. Centro de Periodismo Investigativo Inc.*, 35 F.4th 1, 17 (1st Cir. May 17, 2022). To read ABI’s story, [click here](#).

The majority on the appeals court panel affirmed the district court’s order denying the motion to dismiss, finding a waiver of sovereign immunity.

In dissent, Circuit Judge O. Rogeriee Thompson found “[a]bsolutely nothing in the text of [Section 106 that] sets forth an intent to abrogate Eleventh Amendment immunity.” *Id.* at 21. Announcing a theme that later persuaded Justice Kagan, Judge Thompson said that the “Supreme Court has repeatedly held that jurisdiction-granting clauses like § 106 do not abrogate Eleventh Amendment immunity. [Footnote omitted.]” *Id.* at 22.

Believing there was no abrogation of sovereign immunity, Judge Thompson “respectfully” dissented, ending her opinion by saying that “today’s decision should not go uncorrected.” *Id.* at 25.

The Oversight Board filed a petition for *certiorari* in July 2022. The petition stated the question presented as whether Section 106 of PROMESA abrogated the Oversight Board’s sovereign immunity. The Court granted the petition in October. Argument was held in January.

The Opinion of the Court

Justice Kagan restated the question presented as “whether [PROMESA] categorically abrogates (legalspeak for eliminates) any sovereign immunity the board enjoys from legal claims.”

Telling the reader in the first paragraph that she was reversing, Justice Kagan said:



Under long-settled law, Congress must use unmistakable language to abrogate sovereign immunity. Nothing in the statute creating the Board meets that high bar.

Justice Kagan found nothing “explicit” in PROMESA about the abrogation of sovereign immunity except for Title III cases. “In particular,” she said, “no provision states that it is abrogating any immunity the Board possesses from legal claims.”

“At the same time,” Justice Kagan said, “several provisions of PROMESA contemplate that, even outside the Title III context, the Board may confront legal claims against it.”

Justice Kagan found only two circumstances where Congress has issued an “unequivocal declaration” abrogating immunity. The first is when the statute “says in so many words that it is stripping immunity.” The second “is when a statute creates a cause of action and authorizes suit against a government on that claim.”

“PROMESA fits neither of those molds,” Justice Kagan said.

Reversing the First Circuit and remanding, Justice Kagan held:

In short, nothing in PROMESA makes Congress’s intent to abrogate the Board’s sovereign immunity “unmistakably clear.” *Kimel*, 528 U.S., at 73. The statute does not explicitly strip the Board of immunity. It does not expressly authorize the bringing of claims against the Board. And its judicial review provisions and liability protections are compatible with the Board’s generally retaining sovereign immunity.

The Dissent by Justice Thomas

Justice Kagan said that the First Circuit and the district court “simply assumed the Board’s immunity before turning to the abrogation issue.”

“We took the case on those terms, and we resolve it on those terms,” Justice Kagan said. “That means we assume without deciding that Puerto Rico is immune from suit in federal district court, and that the Board partakes of that immunity.”

Justice Thomas would have affirmed the First Circuit, but on the very ground that the majority assumed without deciding.

Justice Thomas explained how the Oversight Board claimed sovereign immunity under the Eleventh Amendment. He paraphrased the amendment to mean that “the Constitution does not allow federal or state courts to hear cases against States without their consent.”



Working from the proposition that Puerto Rico is a territory and not a state, Justice Thomas said it “is difficult to see how the same inherent sovereign immunity that the States enjoy in federal court would apply to Puerto Rico.” He said that the Oversight Board’s argument for Eleventh Amendment immunity was “untenable.”

Justice Thomas would have affirmed because he believes that the Oversight Board had not established its immunity.

Observations

For Puerto Rico, the case is notable in that the majority ducked the question of whether territories are entitled to sovereign immunity. If the question is ever presented to the Court, the dissent means that Justice Thomas would see no constitutional immunity for territories because they are not states. How he would feel about tribes of Native Americans is less clear.

Indeed, tribal sovereign immunity is *sub judice* in the Supreme Court in *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin*, 22-227 (Sup. Ct.). The case was argued on April 24. Similar to the PROMESA case, the First Circuit had deepened an existing circuit split by holding over a lengthy dissent in *Lac du Flambeau* that Sections 106(a) and 101(27) of the Bankruptcy Code waived sovereign immunity as to Native American tribes. To read ABI’s report on oral argument, [click here](#).

The PROMESA decision doesn’t indicate how the Court will decide *Lac du Flambeau*, except to say that “abrogation requires an ‘unequivocal declaration’ from Congress.” Presumably, the decision in *Lac du Flambeau* will tell us whether “other foreign or domestic government” in Section 101(27) is an unequivocal reference to tribes that waives immunity.

It’s a good bet, however, that Justice Kagan will write the opinion in *Lac du Flambeau*.

[The opinion is](#) *Financial Oversight & Management Board for Puerto Rico v. Centro de Periodismo Investigativo Inc.*, 22-96 (Sup. Ct. May 11, 2023).



Decisions Last Term



The Supreme Court's unanimous opinion avoids saying whether the dual system of U.S. Trustees and Bankruptcy Administrators is itself unconstitutional.

2018 Increase in U.S. Trustee Fees Held Unconstitutional by the Supreme Court

The Supreme Court ruled unanimously on June 6 that the increase in fees payable to the U.S. Trustee system in 2018 violated the uniformity aspect of the Bankruptcy Clause of the Constitution because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees.

The opinion for the Court by Justice Sonia Sotomayor said that the Uniformity Clause “is not a straightjacket: Congress retains flexibility to craft legislation that responds to different regional circumstances that arise in the bankruptcy system.” She remanded for lower courts to determine the proper remedy.

Although Justice Sotomayor pointedly said that her opinion “does not today address the constitutionality of the dual scheme of the bankruptcy system itself,” some of her language could be read to imply that the dual system is constitutionally questionable.

The Fee Structure's History

Justice Sotomayor recounted how U.S. Trustees were originally a pilot program after the adoption of the Bankruptcy Code in 1978. In 1986, Congress expanded the program nationwide, but not in North Carolina and Alabama, where she said there was “resistance from stakeholders.” Courts in those states retained their Bankruptcy Administrators.

The U.S. Trustee system was designed to be self-funding, with fees paid by chapter 11 debtors in 48 states. Originally, Congress did not require user fees in the two exempted states. After the Ninth Circuit held in 1995 that the dual system was unconstitutional in view of the disparate fees, Congress rewrote the law to say that the Judicial Conference “may” requires fees in Bankruptcy Administrator districts to be equal to those in the other 48 states.

Fees in all states were the same until Congress raised the fees in January 2018 for the U.S. Trustee system. Justice Sotomayor said the increase was “significant.”

The Judicial Conference did raise the fees in the two other states effective in October 2018. There were two differences, Justice Sotomayor said.



First, the increase was not effective in the two states until October 2018, while the U.S. Trustee fees had risen everywhere else in January 2018. Second, the increase in the two states only applied to newly filed cases. In U.S. Trustee districts, the increase applied to pending cases, not only new cases.

Procedural History

Circuit City Stores Inc., the debtor that brought the case to the Supreme Court, had confirmed a chapter 11 plan in 2010. Until the increase went into effect, the debtor had been paying \$30,000 a quarter, the maximum.

In the period after the increase, the debtor paid \$632,500 in fees. Had there been no increase, Justice Sotomayor said the fees during the period would have been only \$56,400.

The debtor mounted an objection to the increase on constitutional grounds and won. Bankruptcy Judge Kevin R. Huennkens of Richmond, Va., held that the increased fees violated the Uniformity Clause, if the fee is seen as a tax, and violated the Bankruptcy Clause, if the fee is considered a user fee. *In re Circuit City Stores Inc.*, 606 B.R. 260 (Bankr. E.D. Va. July 15, 2019). To read ABI's report, [click here](#).

However, the bankruptcy court did not rule on whether the debtor was entitled to a refund, Justice Sotomayor said.

The Fourth Circuit agreed to hear an interlocutory appeal and reversed in a 2/1 decision. The majority on the Richmond, Va.-based appeals court did not believe that the increase was arbitrary. The dissenter would have held the increase to be unconstitutional. *In re Circuit City Stores, Inc.*, 996 F.3d 156 (4th Cir. April 29, 2021). To read ABI's report, [click here](#).

Like the Fourth Circuit, the Fifth Circuit saw no constitutional infirmity. There were dissenters in both opinions. In unanimous opinions, the Second and Tenth Circuits found constitutional transgressions. The Supreme Court granted *certiorari* to resolve the circuit split and heard oral argument on April 18.

Applicability of the Bankruptcy Clause

The Bankruptcy Clause empowers Congress to “establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.”

Defending the disparate fee structure, the U.S. Solicitor General argued that the fees were not covered by the Bankruptcy Clause because the fee statutes were not substantive law.



The language of the clause is “broad,” Justice Sotomayor said, and “[n]othing in the language of the Bankruptcy Clause itself, however, suggests a distinction between substantive and administrative laws.” Furthermore, she said that the Court has never “distinguished between substantive and administrative bankruptcy laws or suggested that the uniformity requirement would not apply to both.”

“Not surprisingly,” Justice Sotomayor said, all courts to consider the question have concluded that the fees were subject to the Bankruptcy Clause, including those courts that found no constitutional violation.

“Moreover,” Justice Sotomayor said, the fees were substantive because they affected the debtor/creditor relationship by making less money available for creditors in 48 states. She said that Congress exempted debtors from the higher fees in two states “without identifying any material difference between debtors across those States.”

Precedent Foretells the Outcome

Having decided that the fee structure was subject to the Bankruptcy Clause, Justice Sotomayor addressed the question of whether the disparate fees were “a permissible exercise of that Clause.” She discussed the three Supreme Court cases that have confronted the meaning of the clause. “Taken together,” she said, “they stand for the proposition that the Bankruptcy Clause offers Congress flexibility, but does not permit arbitrary geographically disparate treatment of debtors.”

In 1908 under the former Bankruptcy Act, Justice Sotomayor said that the Supreme Court upheld the constitutionality of state homestead and exemption laws, because the general operation of the law was uniform, although the results might be different in some states. *Hanover Nat. Bank v. Moyses*, 186 U.S. 181, 187 (1902).

In 1974, the Court upheld a railroad reorganization law that only applied to railroads in the Northeast and Midwest. Based on the “flexibility” in the Bankruptcy Clause, the Court upheld the law that addressed “geographically isolated problems.” *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 159 (1974).”

Justice Sotomayor read *Regional Rail Reorganization Act Cases* to mean that “Congress may enact geographically limited bankruptcy laws consistent with the uniformity requirement if it is responding to a geographically limited problem.”

In *Railway Labor Executives’ Assn. v. Gibbons*, 455 U.S. 457 (1982), the Court struck down a railroad reorganization law that changed the priority scheme, but only for one railroad.



From the three cases, Justice Sotomayor said that the Bankruptcy Clause “does not give Congress free rein to subject similarly situated debtors in different States to different fees because it chooses to pay the costs for some, but not others.”

In other words, the clause permits “flexibility, but does not permit arbitrary geographically disparate treatment of debtors,” Justice Sotomayor said.

Impermissible Lack of Uniformity

For Justice Sotomayor, the “only remaining question” was “whether Congress permissibly imposed nonuniform fees because it was responding to a funding deficit limited to the Trustee Program districts.”

In the case in the Supreme Court, the geographical discrepancy cost Circuit City more than \$500,000, Justice Sotomayor said. She said that the budgetary shortfall in the U.S. Trustee districts:

existed only because Congress itself had arbitrarily separated the districts into two different systems with different cost funding mechanisms, requiring Trustee Program districts to fund the Program through user fees while enabling Administrator Program districts to draw on taxpayer funds by way of the Judiciary’s general budget.

The reasons for the different fees, Justice Sotomayor said, “stem not from an external and geographically isolated need, but from Congress’ own decision to create a dual bankruptcy system funded through different mechanisms in which only districts in two States could opt into the more favorable fee system for debtors.”

Consequently, Justice Sotomayor held that “the Clause does not permit Congress to treat identical debtors differently based on an artificial funding distinction that Congress itself created.”

Final Comments by Justice Sotomayor

The debtor took the position in the Supreme Court that the dual system itself is unconstitutional. Justice Sotomayor said that the Court was not addressing “the constitutionality of the dual scheme of the bankruptcy system itself.”

Indicating that the Court was not overruling the *Regional Rail Reorganization Act Cases*, Justice Sotomayor said the opinion “should not be understood to impair Congress’ authority to structure relief differently for different classes of debtors or to respond to geographically isolated problems.” Rather, she said that the court was only prohibiting “Congress from arbitrarily burdening only one set of debtors with a more onerous funding mechanism than that which applies to debtors in other States.”



Justice Sotomayor ended her opinion by noting how the government and the debtor disagreed about the remedy in the event of reversal. Because the Fourth Circuit had not considered remedy, she reversed and remanded for the Fourth Circuit to consider remedy “in the first instance.”

Is the Dual System Constitutionally Sound?

In the context of disparate fees, Justice Sotomayor noted how the Ninth Circuit said that the dual system of U.S. Trustees and Bankruptcy Administrators was unconstitutional. *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525 (1994), *amended*, 46 F.3d 969 (1995). The question never went to the Supreme Court because Congress quickly brought the fees in line.

Litigants may have difficulty attacking the dual system on appeal given the requirement of showing actual pecuniary harm. Furthermore, does the Constitution mandate that all debtors have the same adversary? And if all debtors must have the same adversary, are court-appointed trustees constitutional in chapters 7 and 13? In other words, overturning the dual system would have wide ramifications.

Several statements by Justice Sotomayor might bear on the constitutionality of the dual system. Early in the opinion, she said that “Congress itself had arbitrarily separated the districts into two different systems.” She also said that Congress may “enact geographically limited bankruptcy laws consistent with the uniformity requirement in response to a geographically limited problem.”

Is the dual system unconstitutional simply because it is arbitrary? Is the dual system unconstitutional just because there was no geographical mandate? Laws are not unconstitutional just because they are arbitrary.

Although the constitutionality of the dual system is unclear, this writer believes that the system is subject to scrutiny under the Bankruptcy Clause, because Justice Sotomayor several times said the clause must be brought to bear whether the law is substantive or “administrative.”

Although the disparate fees are ancient history, the last chapter has not been written. Absent settlement, the lower courts in the *Circuit City* case can decide on remand whether the debtor is entitled to a refund.

The same issue is alive in a now-revived class action that could end up giving refunds to chapter 11 debtors throughout the country that paid higher fees.

The Federal Court of Claims dismissed a class action on ruling that the disparate fees did not violate the Bankruptcy Clause. *See Acadiana Management Group LLC v. U.S.*, 19-496, 151 Fed. Cl. 121 (Ct. Cl. Nov. 30, 2020).



The debtor-plaintiff appealed and is asking the Federal Circuit to reinstate the class action. Oral argument in the Federal Circuit was postponed pending the outcome in *Circuit City*. For ABI's report on *Acadiana*, [click here](#).

The opinion is *Siegel v. Fitzgerald*, 21-441 (Sup. Ct. June 6, 2022).



The government has filed a petition for certiorari raising the question of whether refunds are the proper remedy following the Supreme Court's Siegel decision finding that the 2018 increase in U.S. Trustee fees was unconstitutional.

Three Circuits Now Require Refunds for Overpayment of U.S. Trustee Fees

Three circuits have now held that chapter 11 debtors are entitled to refunds for having paid more in U.S. Trustee fees between 2018 and 2021 than debtors were assessed in the two states with Bankruptcy Administrators rather than U.S. Trustees.

The June 23 opinion from the Eleventh Circuit is significant because the government filed a petition for *certiorari* in the Supreme Court on the very same day, raising precisely the same issue. Based on Supreme Court precedent, the Eleventh Circuit opinion by Circuit Judge R. Lanier Anderson, III refutes the government's arguments aimed at persuading the high court that debtors are not entitled to refunds.

Judge Anderson said that "the long line of similar state tax cases [decided in the Supreme Court] are closely analogous to the instant case and provide strong precedent supporting the refund remedy urged upon us by the Debtors."

There being no split of circuits, the Eleventh Circuit's decision and its rationale lower the odds of a grant of *certiorari* by the Supreme Court. A class action pending in the Court of Federal Claims in Washington, D.C., might mean a refund for debtors nationwide. See *Acadiana Management Group LLC v. U.S.*, 19-496 (Ct. Cl.).

Siegel and the Decisions on Remedy

The Supreme Court held last term in *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (Sup. Ct. June 6, 2022), that the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee System was unconstitutional because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees. To read ABI's report, [click here](#).

Siegel left open the question of whether debtors are entitled to refunds. *Id.* at 1783. In August and November 2022, the Tenth and Second Circuits summarily granted refunds to debtors who had challenged the increase. See *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 20-3203, 2022 WL 3354682 (10th Cir. Aug. 15, 2022), reinstating 15



F.4th 1011, 1025-26 (10th Cir. 2021); and *Clinton Nurseries Inc. v. Harrington (In re Clinton Nurseries Inc.)*, 53 F.4th 15, 29 (2d Cir. 2022), amending and reinstating 998 F.3d 56, 69-70 (2d Cir. 2021). To read ABI's reports, click [here](#) and [here](#).

A chapter 11 debtor in Florida had confirmed a plan in 2017 and filed a motion in 2019 protesting the increase in fees that became effective in 2018, but not in the two states with Bankruptcy Administrators. On direct appeal, the Eleventh Circuit upheld the bankruptcy court and found no constitutional violation. *In re Mosaic Mgmt. Grp. Inc.*, 22 F.4th 1291 (11th Cir. 2022), vacated *sub nom. Bast Amron LLP v. United States Trustee Region 21*, 142 S. Ct. 2862 (2022). To read ABI's report on the first decision from the Eleventh Circuit, [click here](#).

The Florida debtor filed a petition for *certiorari* in the Supreme Court, which the Court held in abeyance pending the outcome in *Siegel*. Days after the *Siegel* decision, the Supreme Court granted *certiorari*, vacated the circuit court's judgment and remanded for consideration in light of *Siegel*. *Bast Amron LLP v. U.S. Tr. Region 21*, 142 S. Ct. 2862 (2022).

Refund Directed on Remand

On remand, Judge Anderson said the circuit was tasked with finding "the appropriate remedy for the constitutional violation the Supreme Court found in *Siegel*." He said there were two options: prospective relief or retrospective relief.

Sought by the government, prospective relief could take two forms: (1) The first form, equalizing the fees between U.S. Trustee and Bankruptcy Administrator districts, had been accomplished in January 2021 when Congress mandated that the fees be the same going forward; (2) the second form of prospective relief would entail collecting higher fees from debtors in Bankruptcy Administrator districts.

Neither form of prospective relief would mean recovery by the debtors that paid higher fees.

To remedy the equal-protection problem, the debtor in the Eleventh Circuit wanted retrospective relief in the form of a refund of overpayments.

Selecting the proper relief, Judge Anderson said, "should be guided by Congressional intent." In that regard, he cited "a long line of Supreme Court cases holding that a state's unequal taxation of comparable and competing taxpayers violates the Equal Protection Clause, and holding that the taxpayer who was required to pay the higher, discriminatory tax is entitled to a refund."

Judge Anderson "readily rejected" the government's idea that the court should order debtors in Bankruptcy Administrator districts to pay higher fees. He said that neither those debtors nor the Bankruptcy Administrators were before the court, giving the court no jurisdiction.



Citing *Reich v. Collins*, 513 U.S. 106 (1994), and *Newsweek Inc. v. Florida Department of Revenue*, 522 U.S. 442 (1998), Judge Anderson addressed the government’s “primary argument” that Congress had already given prospective relief by equalizing the fees in early 2021. He said that the government’s idea “has been squarely rejected by the Supreme Court” in those two cases. He paraphrased them to mean that “due process would not permit the state to insist on the predeprivation remedy to the exclusion of the postdeprivation refund remedy unless the exclusivity of the predeprivation remedy was clear such that reasonable persons would not be misled.”

“In other words,” Judge Anderson said, “except in the unusual context of a clear, exclusive predeprivation remedy, the past inequality must be accounted for and the disfavored taxpayer is entitled to appropriate refunds.” He added that the case before him was in precisely the same posture as the taxpayers in *Reich* and *Newsweek*.

By requiring refunds, Judge Anderson said he was “following the ‘normal rule of retroactive application’ of Supreme Court decisions,” citing *Harper v. Va. Dept. of Taxation*, 509 U.S. 86, 97 (1993).

Judge Anderson ended his opinion by noting how he reached the same result as the Second and Tenth Circuits. Although those courts “provided no rationale at all,” he said, “our sister circuit courts probably were thinking along the lines of the analysis we set out in this opinion.”

Reversing and remanding, Judge Anderson held that “the appropriate remedy in this case for the constitutional violation identified in *Siegel* is the refunds that the Debtors in this case seek.”

The Concurrence

Circuit Judge Andrew L. Brasher wrote a concurring opinion. When the case first came to the Eleventh Circuit, he wrote a six-page concurrence in the judgment that read like a dissent.

Originally, Judge Brasher concurred in the result given his belief that the debtor was not entitled to the remedy it sought: a refund of the overpayment. In his view, the “proposed remedy contravenes the intent of Congress.” *Mosaic, id.*, 22 F.4th at 1329.

When the case returned to the appeals court, Judge Brasher said that he had “change[d] my bottom-line conclusion.”

“In a case like this one,” Judge Brasher said, the “due process clause commands that the government provide ‘meaningful backward-looking relief,’” because the debtor had “challenged the imposition of the fee at the earliest opportunity in the very bankruptcy case in which the fee was imposed.”



Similarly, Judge Brasher said that the court could not order debtors in the two Bankruptcy Administrator states to pay higher fees. He said that they “have their own due process rights that prevent us from retroactively assessing higher fees in those cases,” because “too much time has passed to increase the fees consistent with due process.”

Judge Brasher “respectfully” concurred in the result.

Observation

Be it coincidence or not, the Eleventh Circuit filed its opinion just minutes before 5:00 p.m. on June 23, which was also the last day for the government to file a petition for *certiorari* in *John Q. Hammons Fall*. Indeed, the government had filed its petition earlier in the day. See *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 22-1238 (Sup. Ct.).

Had the appeals court filed its opinion even a few hours earlier, the government might have revised the *certiorari* opinion to include a rebuttal of the Eleventh Circuit. As it now stands, the government will be devoting the bulk of its reply brief to the Eleventh Circuit opinion.

On the petition for *certiorari*, there are two glimmers of hope for the government. First, the Second and Tenth Circuit opinions lacked astute analysis of remedy. Second, the concurrence by Judge Brasher was based on the fact that the debtor sought a refund in its own bankruptcy case.

Acadiana is the class action in the federal Court of Claims seeking a refund for all debtors who overpaid U.S. Trustee fees. The government could argue that the debtors are not entitled to a refund under Judge Brasher’s analysis because they did not challenge the higher fees in their own bankruptcies.

It comes down to this: Granting the *Hammons Fall* petition for *certiorari* is unlikely, since there is no circuit split. In the *Acadiana* class action, the government might have a better chance of convincing the Court of Claims or the Federal Circuit to deny refunds because they were not being sought by the debtors in their own bankruptcies.

[The opinion is](#) *U.S. Trustee Region 21 v. Bast Amron LLP (In re Mosaic Management Inc.)*, 20-12547 (11th Cir. June 23, 2023).



All three courts to confront the question have now ordered the government to refund overpayments of U.S. Trustee fees.

The Best Opinion Yet Ordering Refunds for Overpayment of U.S. Trustee Fees

Last term, the Supreme Court held in *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (Sup. Ct. June 6, 2022), that the 2018 increase in fees paid by chapter 11 debtors to the U.S. Trustee System was unconstitutional because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees.

The Supreme Court left open the question of whether debtors are entitled to refunds. *Id.* at 1783. To read ABI's report on *Siegel*, [click here](#). Now, three courts have held that chapter 11 debtors are entitled to refunds.

In August and November, the Tenth and Second Circuits summarily granted refunds to debtors who had challenged the increase. See *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 20-3203, 2022 BL 284318, 2022 US App Lexis 22859, 2022 WL 3354682 (10th Cir. Aug. 15, 2022); and *Clinton Nurseries Inc. v. Harrington (In re Clinton Nurseries Inc.)*, 53 F.4th 15 (2d Cir. Nov. 10, 2021). To read ABI's reports, click [here](#) and [here](#).

After the reversal and remand from the Supreme Court in *Siegel*, the Fourth Circuit in turn remanded the case to Bankruptcy Judge Kevin R. Huennekens in Richmond, Va., to determine the proper remedy.

In the most comprehensive opinion so far on remedy, Judge Huennekens held that “[i]t is a core duty of the federal courts to provide remedies for legal injuries.” In an opinion on December 15, he ruled that the debtor is entitled to a refund, “the only relief [the court] has power to provide.”

The Procedural Posture

The debtor in Judge Huennekens' court was Circuit City Stores, which had been in chapter 11 a decade before the increase in U.S. Trustee fees. Indeed, the debtor had confirmed a plan with a liquidating trust.

For the period in question after the increase, the liquidating trust paid \$632,500 in fees. Had there been no increase, the fees during the period would have been only \$56,400. After paying the



increase, the liquidating trustee sued to recover the overpayment for being in violation of the uniformity aspect of the Bankruptcy Clause of the Constitution.

Bankruptcy Judge Huennekens held the increase to be unconstitutional. On a certified appeal, the Fourth Circuit reversed 2/1. *Siegel*, of course, reversed the Fourth Circuit, putting the question of remedy back in Judge Huennekens' lap.

The Proper Remedy

Judge Huennekens stated the question: “[W]hat is the appropriate remedy to redress the Unconstitutional Overpayment?”

The government argued that prospective relief was sufficient because Congress soon had amended the statute to mandate the same higher fees in Bankruptcy Administrator districts. Judge Huennekens distinguished two Supreme Court opinions finding prospective relief to be sufficient for certain types of constitutional violations.

Judge Huennekens cited other Supreme Court authority for the idea that mandating equal treatment is the remedy when the plaintiff was seeking equal treatment.

Alternatively, the government argued that the courts should pursue debtors in the two Bankruptcy Administrator states to force them to pay the higher fees. According to Judge Huennekens, the government “concede[d] that any such collection attempts may be unsuccessful.”

Judge Huennekens observed that he had no power to compel payments by debtors in other states. Even if there were jurisdiction, he said that “impotently ordering collection in BA Districts is far too speculative and ineffective to accord proper relief to the [liquidating] Trustee.”

There was “ample precedent,” Judge Huennekens said, for ordering a refund; relief already had ordered by the Second and Tenth Circuits. He therefore granted “the only relief [the court] has the power to provide — a refund.”

Judge Huennekens ruled that the liquidating trustee was entitled to a refund for the first three quarters of 2018, when the fees were higher.

Section 549(a) Relief

Section 549(a) permits avoidance of unauthorized post-petition transfers. Citing the section, Judge Huennekens said that the “Bankruptcy Code also provides a means of recovery of the Unconstitutional Overpayment.”



Although the court had authorized the payment, Judge Huennekens said that he had not authorized the payment of unconstitutional fees. Likewise, the Bankruptcy Code does not authorize payment of unconstitutional fees.

Because the liquidating trustee transferred property during the case that was not authorized, Judge Huennekens said that the trustee could avoid the transfers and recover the overpayments.

The government has filed an appeal.

Good News for the Class Action Plaintiffs

The decision by Judge Huennekens is particularly good news for the class plaintiffs in the Court of Federal Claims in Washington, D.C., in *Acadiana Management Group LLC v. U.S.*, 19-496 (Ct. Cl.). The suit seeks a refund on behalf of all chapter 11 debtors around the country who paid the increase.

Originally, the Court of Claims sided with the government and dismissed the suit, believing there was no constitutional violation. *Siegel* came down while the class plaintiffs' appeal was pending in the Federal Circuit. In September, the Federal Circuit vacated the lower court's decision and remanded for further proceedings in light of *Siegel*.

By late September, the class plaintiffs had filed a motion for partial summary judgment, asking the Court of Claims to rule that class members are entitled to refunds. Like the defendants in the case before Judge Huennekens, the government filed a cross motion to dismiss, contending there is no relief available.

On the cross motions, briefing should be completed in the Court of Claims early in the first quarter of 2023.

[The opinion is *Siegel v. U.S. Trustee Program \(In re Circuit City Stores Inc.\)*, 19-03091 \(Bankr. E.D. Va. Dec. 15, 2022\).](#)



Reorganization



Solvent Companies and Bad Faith



*Circuit Judge Thomas Ambro prohibits
big companies from filing chapter 11 cases
absent 'financial distress.'*

Third Circuit Reverses and Dismisses J&J's 'Baby Powder' Chapter 11 Case

On direct appeal, the Third Circuit reversed the bankruptcy court and directed dismissal of the petition filed by LTL Management LLC, the subsidiary of Johnson & Johnson created to file in chapter 11 to deal with talc and asbestos claims arising from the sale of Johnson's Baby Powder.

In his 40-page opinion yesterday, Circuit Judge Thomas L. Ambro held that "resort to Chapter 11 is appropriate only for entities facing financial distress." LTL did not qualify because it has a \$61.5 billion backstop from another J&J subsidiary and from the ultimate J&J parent. Judge Ambro said that the parent has \$400 billion in equity value, a AAA credit rating, plus \$31 billion in cash and marketable securities. He also noted that the parent had distributed \$13 billion to shareholders in 2020 and 2021.

Judge Ambro pointedly declined to rule on whether LTL improperly used chapter 11 as a "litigation tactic." Unless the debtor is in "financial distress," this writer reads the opinion to mean that debtors may not justify the use of chapter 11 by contending that it's superior to the tort system or multidistrict litigation in federal courts.

The Pre-Bankruptcy Divisional Merger

The J&J companies were faced with more than 38,000 talc claims. Most prominently, 20 plaintiffs had won a \$2.24 billion judgment in state court. Of the 38 completed trials, Judge Ambro said that fewer than half had given monetary awards to the plaintiffs. In those cases where J&J didn't win and that were not reversed on appeal, Judge Ambro said that the average award was \$39.7 million.

Before bankruptcy, the companies had spent about \$4.5 billion on verdicts, settlements and litigation expenses. In a statement to its auditors, J&J estimated that the companies' probable liabilities for tort claims were \$2.4 billion for the succeeding two years.

Just before the chapter 11 filing, the Johnson & Johnson parent created two new subsidiaries to compartmentalize tort liabilities. LTL was created to be the debtor, and the other took over J&J's operating consumer businesses.



The debtor was first created as a limited liability company in Texas and converted to a North Carolina limited liability company. Two days after its creation, the debtor filed a chapter 11 petition in Charlotte, N.C.

The debtor took no business operations of its own but assumed liability for all talc-related claims. The debtor was given some non-operating assets and insurance receivables, plus \$6 million in cash. The debtor was also the beneficiary of a so-called funding agreement.

Judge Ambro's decision to dismiss was founded on the funding agreement. He explained that that the newly created sister corporation with the operating business and the J&J parent together committed to supply LTL with up to \$61.5 billion in cash, representing the value of the consumer businesses.

"Most important, though," Judge Ambro said that the funding agreement "gave LTL direct access to J&J's exceptionally strong balance sheet," which, he said, had \$400 billion in equity value and \$31 billion in cash and marketable securities.

Judge Ambro said that the "stated goal was to isolate the talc liabilities in a new subsidiary so that entity could file for Chapter 11 without subjecting [the operating company's] entire operating enterprise to bankruptcy proceedings."

The Transfer to New Jersey

LTL filed a chapter 11 petition in North Carolina that the bankruptcy judge soon transferred to New Jersey, where the official committee representing talc claimants filed a motion to dismiss the chapter 11 case under Section 1112(b), contending that the filing was in bad faith.

The New Jersey bankruptcy court denied the motion to dismiss, finding that LTL was in financial distress, had filed for a valid bankruptcy purpose and had not pursued bankruptcy for litigation advantage. Judge Ambro noted how the bankruptcy court had a "strong conviction" that the bankruptcy court possessed "a superior ability, compared to trial courts, to protect the talc claimants' interests."

The bankruptcy court also granted the debtor's motion to spread the automatic stay by enjoining lawsuits against more than 600 nondebtors, including the parent and LTL's affiliates. To read ABI's report on denial of the dismissal motion, *In re LTL Management LLC*, 637 B.R. 396 (Bankr. D.N.J. Feb. 25, 2022), [click here](#).

The bankruptcy court authorized a direct appeal, which the Third Circuit agreed to hear. The appeals court heard oral argument on September 19.

Third Circuit Precedent on Financial Distress



On the merits, Judge Ambro portrayed his opinion as being cabined by Third Circuit precedent, principally *In re SGL Carbon Corp.*, 200 F.3d 154 (3d Cir. 1999), and *NMSBPCSLDHB L.P. v. Integrated Telecom Express Inc. (In re Integrated Telecom Express Inc.)*, 384 F.3d 108 (3d Cir. 2004). Under those authorities, he said that the “particularly relevant” inquiries were whether there was a valid bankruptcy purpose and whether the filing was merely for tactical litigation advantage. Given his conclusions, Judge Ambro was only obliged to examine “valid bankruptcy purpose.”

“Our precedents show,” Judge Ambro said, that “a debtor who does not suffer from financial distress cannot demonstrate its Chapter 11 petition serves a valid bankruptcy purpose supporting good faith.” Conversely, “absent financial distress, there is no reason for Chapter 11 and no valid bankruptcy purpose.”

However, financial distress does not require insolvency. Without describing how much distress must be shown, Judge Ambro said that it must be “apparent” and “immediate enough to justify a filing.” In a mass tort case, he said that filing later rather than sooner is preferable, because the outcome of tort litigation will enable the bankruptcy court to estimate claims more accurately.

By way of comparison, Judge Ambro said that the bankruptcies of Johns Manville, A.H. Robbins and Dow Corning demonstrated “urgency” and a “compelling need for bankruptcy relief.”

Bankruptcy Court’s Findings Overturned

In applying the standard, Judge Ambro disagreed with the bankruptcy court and analyzed only the financial distress of LTL. He said that the bankruptcy court’s finding of LTS’s financial distress was “untenable,” given the \$61.5 billion payment right” against the consumer products operating company and parent J&J.

Specifically, Judge Ambro said that the funding agreement gave “LTL direct access to J&J’s exceptionally strong balance sheet.” He said that the bankruptcy court “hardly considered” LTL’s payment right.

With regard to LTL’s potential liabilities, Judge Ambro questioned whether the bankruptcy court had made “factual findings” but instead developed “back-of-the-envelope forecasts of hypothetical worst-case scenarios.” He said that the bankruptcy court ignored the “possibility of meaningful settlement” and “successful defense” in assuming that “most, if not all, would go to and succeed at trial.”

For Judge Ambro, it was “clear” that “LTL did not have any likely need in the present or the near-term, or even in the long-term, to exhaust its funding rights to pay talc liabilities.” He could “infer only that LTL, at the time of its filing, was highly solvent with access to cash to meet comfortably its liabilities as they came due for the foreseeable future.”



But what if circumstances change and there are other judgments for \$2.24 billion? “Perhaps at that time,” Judge Ambro said, “LTL could show that it belonged in bankruptcy.”

“Because LTL was not in financial distress,” Judge Ambro held that “it cannot show its petition served a valid bankruptcy purpose and was filed in good faith under Code § 1112(b).” He also said there were no “unusual circumstances” under Section 1112(b)(2) to avert dismissal.

By calling for the dismissal of the chapter 11 case, Judge Ambro said that the appeal from the broadened stay was moot.

The opinion is [In re LTL Management LLC, 22-2003](#) (3d Cir. Jan. 30, 2023).



Bound by the Third Circuit's first LTL decision, the bankruptcy court found that LTL's rejiggered second filing suffered from the same defect: no immediate financial distress.

J&J's 'Baby Powder' Chapter 11 Case Dismissed a Second Time: No Financial Distress

Twice within six months, Johnson & Johnson has suffered dismissal of chapter 11 petitions filed by a subsidiary that aimed to resolve asbestos liability for the entire corporate family, debtors and nondebtors alike.

The new dismissal will result from the July 28 opinion by Chief Bankruptcy Judge Michael B. Kaplan of Trenton, N.J. At the end of January, the Third Circuit reversed Judge Kaplan and ordered him to dismiss the first “Baby Powder” case because it was not filed in good faith given the lack of “financial distress.” See *In re LTL Management LLC*, 58 F.4th 738, 64 F.4th 84 (3d Cir. Jan. 30, 2023). To read ABI’s report on *LTL II*, [click here](#).

Two hours after Judge Kaplan signed the dismissal order required by the Third Circuit in *LTL II*, J&J put the same subsidiary back into chapter 11. The new filing was accompanied by support agreements signed by lawyers saying they represented almost 60,000 asbestos claimants. In addition, the new filing had a different funding agreement with nondebtor J&J companies.

Bound by *LTL II* in his new opinion on July 28, Judge Kaplan directed dismissal of the new filing because there was no “imminent and immediate financial distress.”

The New Filing

LTL Management LLC was first created as a limited liability company in Texas and converted to a North Carolina limited liability company. Two days after its creation, the debtor filed a chapter 11 petition in Charlotte, N.C., that was transferred to New Jersey.

The creation of LTL was part of a so-called Texas divisional merger. The debtor LTL took no business operations of its own but assumed liability for all talc-related claims.

After being spurned by the Third Circuit, LTL filed a chapter 11 petition again on April 4. Dismissal of the first LTL case didn’t occur immediately after the Third Circuit’s January 30 opinion because the debtor filed unsuccessful petitions in the circuit for rehearing and rehearing *en banc* and for a stay of the circuit’s issuance of the mandate.



The new filing was accompanied by plan support agreements endorsed by lawyers allegedly representing almost 60,000 claimants who said they were injured by using J&J's Baby Power, which allegedly contained asbestos. If confirmed, the plan described in the support agreements would have created an \$8.9 billion trust at net present value. The funding agreement in the first chapter 11 case provided the debtor LTL with perhaps \$61.5 billion to cover liabilities arising from the talc contained in Baby Powder that allegedly contained asbestos.

The J&J companies terminated the funding agreement that underpinned the first LTL filing. The new funding agreement obligates nondebtor J&J companies to pay for asbestos liabilities and other costs incurred in the normal course of business. The new agreement also has backstop funding for a chapter 11 plan, but only if the confirmed plan is consistent with the plan support agreements.

Soon after the new filing, Judge Kaplan entered a temporary restraining order imposing a stay on talc lawsuits. The new TRO protected both LTL and potentially hundreds of other nondebtor third parties, including the J&J parent and affiliates. As required on issuance of a TRO, Judge Kaplan scheduled a preliminary injunction hearing to be held on April 18. Two days later, he issued his opinion from the bench, vacating the original TRO while imposing a more limited preliminary injunction. He followed the bench opinion with a written opinion. *LTL Management v. Those Parties Listed on Appendix A (In re LTL Management LLC)*, 23-01092, 2023 BL 143084 (Bankr. D.N.J. April 27, 2023). To read ABI's report, [click here](#).

In issuing the injunction, Judge Kaplan said he would revisit the injunction once again at a hearing that began in late June. At the same four-day evidentiary hearing, he also considered 10 motions to dismiss and two joinders filed by parties in interest who argued that the new filing, like its predecessor, was in "bad faith."

Reasons for the Second Dismissal

The motions to dismiss contended there was "cause" for dismissal under Section 1112(b) because the new petitions were not filed in good faith. To qualify for chapter 11 relief, Judge Kaplan characterized the Third Circuit as having held in *LTL II* "that the Debtor's financial distress must be 'immediate, 'imminent' and 'apparent.'"

Given the new funding agreement, Judge Kaplan found "no immediate financial distress," because even the forced liquidation value of the affiliates providing the funding "could cover the Debtor's total estimated worst-case scenario for talc liability."

Although he found "cause" for dismissal, Judge Kaplan identified Section 1112(b)(1) and (2) as requiring him to decide whether continuing the chapter 11 case would be "in the best interest of creditors."



Judge Kaplan assumed, without finding, that “unusual circumstances” existed under Section 1112(b)(2) to obviate dismissal, and “the possibility that best interests of the creditors warrants continuation of this chapter 11 case” under Section 1112(b)(1).

Judge Kaplan held that the debtor’s lack of financial distress is not the type of bad faith “that could be subject” to the Section 1112(b)(2) exception to prevent dismissal. He said it was “clear” under Third Circuit precedent that “an alternative to dismissal is reserved for only those who properly belong in bankruptcy,” and the debtor LTL wasn’t properly in bankruptcy for lack of financial distress.

Before ending his decision, Judge Kaplan rejected the idea of appointing a trustee or examiner as an alternative to dismissal under Section 1112(b)(1).

While directing the parties to settle an order dismissing the case for “lack of imminent and immediate financial distress,” Judge Kaplan “strongly encouraged” everyone “to continue to pursue a global resolution.”

Unique Aspects of the Opinion

Not bearing directly on the debtor’s lack of financial distress, Judge Kaplan salted his opinion with language that could be used by courts more receptive to mass tort bankruptcies.

Judge Kaplan said that his “beliefs as to the benefits and advantages of bankruptcy, or the appropriateness of employing a chapter 11 filing to resolve mass tort liability, are of no moment for resolution of the pending Motions” to dismiss. He nonetheless questioned whether requiring immediate financial distress was in the best interests of the estate or creditors.

Waiting to pursue chapter 11 relief until distress is imminent “often gives rise to serious risks and increased costs that may threaten the viability of the business,” Judge Kaplan said. He added, “Drawing upon the history of mass tort bankruptcies, most companies fare no better when trying to ride out massive, decades-long litigation firestorms.”

Judge Kaplan offered his thoughts on the superiority of bankruptcy over the tort system when satisfying the claims of creditors. He alluded to “the incontrovertible fact that many plaintiffs are denied any recovery in the tort system altogether.” He was also troubled by the “sluggish speed of the tort system” and “the need to protect the interests of future claimants.”

With regard to a global settlement outside of bankruptcy, Judge Kaplan said:



No party or expert has identified even a single example of a global settlement outside of bankruptcy that has been achieved in circumstances like this case — where both latent injuries and unknown future claimants exist.

Similarly, Judge Kaplan was “unconvinced that procedural mechanisms and notice programs” would protect future claimants in the tort system.

Judge Kaplan was constrained to dismiss because he read the Code as precluding him from considering the best interests of creditors given a bad faith filing for lack of financial distress.

The opinion is [LTL Management LLC, 23-12825](#) (Bankr. D.N.J. July 28, 2023).



The Fourth Circuit majority upheld a preliminary injunction barring tort suits against a debtor's nonbankrupt affiliates following a Texas divisional merger.

A Fourth Circuit Dissenter Opposes Mass-Tort Injunctions Protecting Non-Debtors

A dissenter in the Fourth Circuit is the latest example of an Article III judge antagonistic to idea of allowing large, solvent companies to fend off their own mass tort liability by putting an affiliate into chapter 11.

Espousing a new strategy for precluding the use of the bankruptcy court in obtaining the release of tort liability for non-debtors, Circuit Judge Robert Bruce King would have ruled that the use of a so-called Texas divisional merger manufactured federal jurisdiction in violation of 28 U.S.C. § 1359.

On the last page of the opinion in which he “respectfully” dissented, Judge King quoted an *amicus* brief filed in the Seventh Circuit on behalf of six U.S. senators and two representatives, urging the appeals court to uphold denial of non-debtor injunctions in the chapter 11 reorganization of a subsidiary of 3M Corp. The *amici* said:

[I]n recent years, the Bankruptcy Code has increasingly been manipulated by solvent, blue-chip companies faced with mass tort liability and is becoming a font for abuse by mammoth corporations with billions on their balance sheets. Through dubious readings of the Bankruptcy Code that Congress never intended, financially healthy corporations and those that control them have invented elaborate loopholes enabling them to pick and choose among the debt-discharging benefits of bankruptcy without having to subject themselves to its creditor-protecting burdens — and without ever declaring bankruptcy themselves.

In re Aearo Techs., LLC, No. 22-2606, at 3-4 (7th Cir. Feb. 1, 2023), ECF No. 89.

Upholding the lower courts’ conclusions that the bankruptcy court had “related to” jurisdiction, the Fourth Circuit majority found no abuse of discretion in issuing a preliminary injunction barring suits against non-debtor affiliates.

The Georgia-Pacific Divisional Merger



The facts were similar to those where Johnson & Johnson employed a Texas divisional merger to segregate mass tort liability into a subsidiary that would file a chapter 11 petition to obtain an injunction barring suits against the entire non-debtor corporate family.

In 1965, Georgia-Pacific merged with Bestwall Gypsum, which made products containing asbestos. Thousands of lawsuits ensued.

In 2017, GP underwent a Texas divisional merger. The “old” GP ceased to exist. Two companies were created in its place. Bestwall became solely responsible for mass tort liability, while a newly created company, that we shall refer to as New GP, received all of the assets of “old” GP but was not responsible for any asbestos liability.

Both Bestwall and New GP became wholly-owned subsidiaries of a holding company. Just like the J&J, Bestwall could draw on a funding agreement requiring New GP to pay any asbestos liabilities, in bankruptcy or outside of bankruptcy.

Following the divisional merger, Bestwall filed a chapter 11 petition in Charlotte, N.C. Immediately, the debtor filed an adversary proceeding and sought a preliminary injunction to halt lawsuits against New GP.

Finding “related to” jurisdiction under Section 1334, the bankruptcy granted the preliminary injunction. On appeal by the official creditors’ committee and the future claimants’ representative, the district court affirmed. The committee and the representative appealed to the Circuit.

The Majority Opinion

The appellants argued on appeal that the bankruptcy court lacked jurisdiction to impose the preliminary injunction.

For the majority, Circuit Judge G. Steven Agee said that the Fourth Circuit uses a “broad test” for “related to” jurisdiction under Section 1334(a). He said that the asbestos claims against New GP are “identical” to those against Bestwall and that the claims against New GP could have an “effect” on Bestwall.

Judge Agee quickly found “related to” jurisdiction and devoted the remainder of his opinion countering the dissenter’s contention that New GP “manufactured” federal jurisdiction in violation of 28 U.S.C. § 1359. The section provides that a “district court shall not have jurisdiction of a civil action in which any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court.”

Judge Agee said that the companies “did not manufacture jurisdiction via their Texas divisional merger.” Absent the merger, he said that the claims would have been asserted against Old GP. If



Old GP had filed bankruptcy, there would have been jurisdiction. He therefore reasoned that the bankruptcy court had the same jurisdiction as though the merger had never taken place.

Judge Agee rejected the creditors' reliance on the Third Circuit's dismissal of the chapter 11 case filed by LTL Management, a subsidiary of Johnson & Johnson. *See In re LTL Management LLC*, 58 F.4th 738, 64 F.4th 84 (3d Cir. Jan. 30, 2023). The Third Circuit, he said, dismissed for a lack of good faith given the absence of "financial distress." To read ABI's report on *LTL*, [click here](#).

The Third and Fourth Circuits have different "good faith" standards. Judge Agee recounted how the Third Circuit "recognized" that the Fourth Circuit employs a "more comprehensive standard" requiring both subjective bad faith and an objective futility of any possible reorganization.

The creditors, Judge Agee said, "made no showing to this Court of either required element." He held that the district court "correctly rejected" the idea that the companies "manufactured jurisdiction."

Judge Agee ended his majority opinion by finding that the bankruptcy court had employed the proper standard for a preliminary injunction.

According to Judge Agee, the debtor had shown the likelihood of success on the merits by demonstrating a "realistic likelihood of successfully reorganizing" and was not required to make a clear showing of the ability to reorganize.

For the majority, Judge Agee upheld the preliminary injunction.

The Dissent

In the first paragraph of his dissent, Judge King quoted the Supreme Court for saying that bankruptcy is for "insolvent" or "bankrupt" companies. In "recent years," he said,

major and fully solvent business corporations have managed to skirt that debtor-centric objective and obtain shelter from sweeping tort litigation without having to file for bankruptcy themselves. It is precisely that sort of manipulation of the Bankruptcy Code . . . that lies at the heart of this important appeal.

Before explaining the legal grounds on which he would have denied the injunction, Judge King said that the companies "manufactured the jurisdiction of the bankruptcy court in these proceedings, in an unmistakable effort to gain leverage over future asbestos claims against New GP."



Judge King said that the divisional merger “was designed [for New GP] to receive bankruptcy protection despite its non-debtor status, with no need to submit to the bankruptcy court’s oversight or to suffer the burdens appurtenant to a Chapter 11 filing.”

Conceding that the claims against New GP were “related to” the bankruptcy, Judge King pointed to Section 1359 and said that “the entire factual basis for invoking the bankruptcy court’s ‘related-to’ jurisdiction was contrived.”

Explaining the applicability of Section 1359, Judge King said that Old GP “reformed its corporate existence precisely so that its principal successor entity, New GP, could be afforded bankruptcy relief without ever having to file for bankruptcy.” He therefore would have held that the bankruptcy court was without jurisdiction to enter the injunction, because “jurisdiction consistently flows from an orchestrated endeavor to fabricate it.”

Judge King would have reversed with directions to vacate the injunction, saying that the injunction runs “directly counter to the purposes of the Bankruptcy Code.”

[The opinion is](#) *Official Committee of Asbestos Claimants v. Bestwall LLC (In re Bestwall LLC)*, 22-1127 (4th Cir. June 20, 2023).



Indianapolis Bankruptcy Judge Jeffrey Graham says that the bankruptcy court cannot become “another court of general jurisdiction.”

J&J, Redux: Bankruptcy Court Dismissed 3M Subsidiary’s Chapter 11 Case

Just like the lack of “financial distress” prompted the Third Circuit to dismiss the first chapter 11 filing by Johnson & Johnson subsidiary LTL Management LLC, Bankruptcy Judge Jeffrey J. Graham of Indianapolis dismissed the chapter 11 case of a subsidiary of 3M Corp. for lack of “financial distress” and no demonstration of a “valid reorganization purpose.”

In his June 9 opinion, Judge Graham said that the filing by 3M subsidiary Aearo Technologies LLC was “fatally premature” and that the debtor was employing chapter 11 to “solve problems that Congress did not design or intend the [Bankruptcy] Code to fix.”

Judge Graham found the Third Circuit’s logic to be “persuasive” in *LTL Management LLC*, 64 F.4th 84 (3d Cir. Jan. 30, 2023). In *LTL*, the Philadelphia-based appeals court held that “resort[ing] to Chapter 11 is appropriate only for entities facing financial distress.” *Id.* at 111. To read ABI’s report on *LTL*, [click here](#).

The June 9 opinion was not 3M’s first disappointment. In August 2022, Judge Graham found no jurisdiction to impose an injunction stopping lawsuits against nondebtors, like the parent 3M. *In re Aearo Tech. LLC*, 642 B.R. 891 (Bankr. S.D. Ind. Aug. 26, 2022). To read ABI’s report, [click here](#).

Aearo took a direct appeal to the Seventh Circuit from the order refusing to enjoin lawsuits against nondebtors. The appeal was argued in early April. Unless Aearo successfully appeals the June 9 dismissal order, the appeal from injunction denial may be moot.

The Faulty Earplugs

Aearo began making earplugs for the military in 2000. 3M acquired Aearo in 2008. Two years later, Aearo’s businesses were “upstreamed” to 3M in return for \$965 million payable to Aearo. Judge Graham said that 80% of earplug sales occurred before the upstreaming. He said it was “unclear” whether 3M assumed any liabilities as part of the upstreaming.

After 3M paid \$9.1 million to settle a *qui tam* action, a deluge of lawsuits were filed alleging that the earplugs were defective. Aearo filed a chapter 11 petition in July 2022 that stopped



lawsuits against Aeero but not against 3M and nondebtor affiliates. Central to the reorganization, the Aeero subsidiary had uncapped funding from the 3M parent to pay judgments or settlements, whether arising in bankruptcy or not.

Immediately after filing, Aeero attempted to spread the Section 362 automatic stay to cover 3M and other nondebtor affiliates, but Judge Graham denied the initiative last August.

Today, more than 250,000 earplug suits are consolidated in multidistrict litigation in Florida, where the debtor and 3M are co-defendants. Judge Graham said that the multidistrict litigation is the largest in history and represents 30% of all civil cases currently pending in federal courts.

So far, there have been 18 bellwether trials. 3M and the debtor won six, but the plaintiffs won 12, yielding verdicts ranging between \$1.7 million and \$77.5 million.

3M called the multidistrict litigation a failure and proffered chapter 11 as the best method for resolving all earplug liabilities.

Perhaps emboldened by the Third Circuit's dismissal of the case by the J&J subsidiary, the earplug plaintiffs filed a motion asking Judge Graham to dismiss the Aeero case under Section 1112(b) for "cause." A separate committee representing plaintiffs who used allegedly defective respirators wanted Judge Graham to appoint a chapter 11 trustee instead.

Judge Graham took the matter under advisement after a five-day hearing concluding on April 25, and issued his 49-page opinion six weeks later dismissing the case without prejudice.

The Financial Condition of the Debtor and 3M

The financial condition of Aeero and 3M was central to Judge Graham's legal conclusions. The debtor's expert estimated that the total earplug liability was less than \$1 billion and that 3M has the ability to pay. Currently, Judge Graham said that Aeero is solvent on a balance-sheet and cash-flow analysis.

3M has book equity today of \$14.7 billion and cash and cash equivalents of more than \$3.6 billion. In 2022, 3M paid over \$3.2 billion in dividends and bought back \$1.4 billion in stock, Judge Graham said.

The Law on Dismissal

On finding "cause," Section 1112(b) directs the court to convert to chapter 7 or dismiss, unless appointment of a chapter 11 trustee or an examiner is in the best interests of creditors. In addition to the 16 statutorily defined grounds for finding cause, Judge Graham said that "most courts generally agree that a case should also be dismissed under § 1112 if it was not filed in good faith."



While there is “no universally accepted definition of good faith” in the Section 1112 context, Judge Graham said it is also “unclear” in Seventh Circuit caselaw “whether it is bad faith for a financially healthy debtor to seek Chapter 11 relief.” Of course, being insolvent is not a prerequisite for chapter 11, he said.

To determine the relevance of the debtor’s financial condition, Judge Graham extensively analyzed a 1990 decision by retired Chicago Bankruptcy Judge Eugene Wedoff in *In re N.R. Guaranteed Retirement Inc.*, 112 B.R. 263 (Bankr. N.D. Ill. 1990). Finding the filing to have been “unnecessary” was the “most basic” ground for dismissal, Judge Wedoff said. *Id.* at 262.

Unwilling to adopt an unweighted, multi-factor test for good faith, Judge Graham cited the Seventh Circuit’s opinion in *In re Madison Hotel Associates*, 749 F. 2d 410, 425 (7th Cir. 1984), for saying that the “better” measure is “whether the Chapter 11 case serves a ‘valid reorganization purpose.’” The “central” question, he said, is the “debtor’s ‘need’ for relief under Chapter 11.”

What’s a ‘Valid Purpose’?

Next, Judge Graham addressed the definition of “valid reorganization purpose.” He said that the need for chapter 11 is “inextricably tied” to bankruptcy “purpose.”

One purpose, Judge Graham said, is to preserve or create value that would be lost outside of bankruptcy. Citing the Third Circuit among other authorities, he reported how courts “have consistently dismissed chapter 11 petitions by financially healthy companies with no need to reorganize under the protection of Chapter 11.”

“When the debtor is solvent,” Judge Graham said, “we begin to stray from Congress’ intended application of the Code and valid bankruptcy purposes dwindle.” The “line of reasoning,” he said, “has arguably been most clearly articulated by the Third Circuit . . . most recently” in *LTL*, where the Court of Appeals found no “financial distress.”

Finding *LTL* “persuasive,” Judge Graham said that “the Court cannot conclude that the Aearo Entities’ cases serve a valid reorganization purpose.” The company “has been, and currently is, financially healthy.” He found “simply no compelling evidence that the Pending Actions have had or will have, at least in the near term, any substantial effect on Aearo’s operations. Aearo, simply put, is thriving even while living under the ‘overhang’ of the largest MDL in history.”

Naturally, Judge Graham said that the uncapped “Funding Agreement plays an obvious and significant factor in the Court’s conclusion that Aearo is financially healthy.”



Turning to the other aspect of reorganization purpose, Judge Graham said “there is no material value preserved, created, or lost outside of bankruptcy.” He could not “conclude that Aearo’s bankruptcy creates or preserves any value that would be lost if these cases were dismissed.”

Judge Graham found “cause” to dismiss the case under Section 1112(b).

No Trustee

The respirator committee wanted a chapter 11 trustee rather than dismissal. Judge Graham said that a trustee was not in the best interests of the estate or creditors, because he did not believe that “a trustee will necessarily add to or aid the process of reaching a global settlement.”

Furthermore, Judge Graham said that the “appointment of a trustee does not ameliorate or obviate the fundamental problem that these cases simply do not, at least presently, serve a valid reorganizational purpose.”

Conclusion

Judge Graham ended his opinion by finding a correlation between his decision to dismiss the case and his prior decision refusing to expand the automatic stay based on the lack of jurisdiction.

Although Section 1112(b) is not jurisdictional, Judge Graham said that requiring a valid bankruptcy purpose “protects this Court’s jurisdictional integrity.”

“Otherwise,” Judge Graham said, “a bankruptcy court risks becoming another court of general jurisdiction, which it most decidedly is not.” He added that allowing “an otherwise financially healthy debtor . . . to remain in bankruptcy . . . exceeds the boundaries of the Court’s limited jurisdiction.”

Judge Graham said that the chapter 11 filing was “fatally premature.” He dismissed the case without prejudice so as not “to forestall a repeat filing . . . should the circumstances warrant it.”

[Disclosure: This writer’s brother is counsel for the Aearo respirator committee.]

[The opinion is](#) *In re Aearo Technologies LLC*, 22-02890 (Bankr. S.D. Ind. June 9, 2023).



District judge remonstrates a solvent parent company for seeking the protections of bankruptcy without filing chapter 11 itself.

It Wasn't a Good Idea for 3M Corp. to Call Its Multidistrict Litigation a 'Failure'

Perhaps it wasn't a good idea for 3M Corp. to say that its multidistrict litigation was a "failure," because the district judge might have an opportunity to get even.

And she did.

The December 22 opinion by District Judge M. Casey Rodgers of Pensacola, Fla., reflects a growing antipathy among some Article III judges regarding the use of chapter 11 by large, solvent companies as an alleged litigation tactic to fend off mass tort liability without filing bankruptcy themselves. Judge Rodgers said that 3M, the nonbankrupt parent in her MDL case, intended to "reap all the benefits of bankruptcy with none of the attendant burdens."

The December 22 decision by Judge Rodgers is a treatise on the court's use of inherent powers "to fill the gaps left by other sanctioning mechanisms." As a sanction, she basically ruled that the 3M parent would be liable for whatever judgments there may be for defective earplugs manufactured by the subsidiary that's in chapter 11 in Indiana. She also barred the 3M parent from contending that the bankrupt subsidiary alone should be liable for judgments.

The Defective-Earplug Lawsuits

A company that is now a subsidiary of 3M Corp. manufactured earplugs sold to the military beginning in 2000. 3M acquired the company in 2008. 3M and the subsidiary were saddled with 290,000 claims alleging that the earplugs were defective. Lawsuits based on the claims were consolidated four years ago into a multidistrict litigation, or MDL, in Judge Rodgers' court in Florida.

The subsidiary filed a chapter 11 petition in Indiana in July. The newly minted debtor immediately filed a complaint asking the bankruptcy judge to enjoin the earplug lawsuits against the 3M parent, because 3M itself did not file for bankruptcy.

In August, the bankruptcy court refused to protect the 3M parent with a stay and certified a direct appeal to the Seventh Circuit. *See 3M Occupational Safety LLC v. Those Parties Listed on Appendix to the Complaint (In re Aearo Technologies LLC)*, 642 B.R. 891 (Bankr. S.D. Ind. Aug.



26, 2022). Briefing in the Seventh Circuit should be completed in the first quarter of 2023. To read ABI's report on the bankruptcy court decision, [click here](#).

According to Judge Rodgers, 3M previously made "explicit statements" in which it conceded its liability for earplug claims. She wrote the December 22 opinion after 3M changed course and began contending that it has no liability whatsoever and that the subsidiary alone should be liable for earplug lawsuits.

Judge Rodgers described the tort plaintiffs in the MDL as responding to 3M's change in strategy by asking her to bar the 3M parent "from attempting to avoid any portion of its alleged liability for the [earplug] claims in this litigation by shifting blame to the" bankrupt subsidiary.

The Law on Inherent Powers

Judge Rodgers granted the tort claimants' motion based on the court's inherent powers, which, she said, "furnishes a legal and contextual framework that allows for consideration of the full range of litigation abuses alleged in this matter."

Judge Rodgers said that a court may exercise its inherent powers to fill in gaps left by other sanctioning mechanisms and may use inherent powers even when there are procedural rules that could sanction the same conduct.

However, Judge Rodgers said that the imposition of sanctions under a court's inherent powers requires conduct tantamount to bad faith. But when "the requirements of due process are met and a finding of bad faith has been made," she said that "a court has 'broad discretion' to fashion an appropriate sanction," citing the Eleventh Circuit.

The Resort to Bankruptcy Court

In the MDL, Judge Rodgers said that the parent litigated on "every theory of liability" but with "nary a whisper" that the subsidiary alone should be liable. "Then came the bellwether trials," where the tort plaintiffs won 16 judgments for almost \$300 million in jury verdicts, she said. The defendants won in six bellwether trials.

"Suddenly," 3M began to say that the MDL was a "failure," and that it wanted "a new forum" and "no more of this MDL nonsense," Judge Rodgers said.

Judge Rodgers observed:

3M devised a scheme to oust the Congressionally-established system for resolving mass tort disputes in Article III courts and install its new favored forum (for the moment, anyway), an Article I court, at the helm. Not because any of the



entities was facing a bona fide threat of financial distress, and not due to managerial or operational difficulties that were jeopardizing the entities' continued viability. No, this was good old-fashioned litigation forum shopping, solely — and admittedly — designed to evade dissatisfactory legal rulings and verdicts in the MDL, and to avoid potential future liability for a non-debtor, 3M, in the tort system.

Judge Rodgers wasn't through. She continued:

And there's the catch. 3M itself was not willing to pay the price of admission to an Article I forum [by] submission to the oversight of a bankruptcy court . . . [T]he company hatched a workaround. [The subsidiary] would file for Chapter 11 bankruptcy protection but seek an extension of the statutory automatic stay of litigation to 3M, who would never file a bankruptcy petition itself.

Judge Rodgers went on to describe how 3M devised a “funding and indemnity agreement” where the subsidiary would assume all liability for earplug claims, but 3M would fund all of the subsidiary's liabilities and costs for the bankruptcy case. 3M believed that the resulting identity of interests would justify the bankruptcy court's imposition of a stay of suits against the 3M parent.

Had the strategy been successful in bankruptcy court, Judge Rodgers said that 3M “would [have reaped] all the benefits of bankruptcy with none of the attendant burdens.” However, the bankruptcy court declined to protect the 3M parent with a stay, subjecting the parent to continuing litigation in the MDL.

Having been rebuffed in bankruptcy court, Judge Rodgers said that 3M “returned to the MDL and sought to rewrite . . . history . . . by asserting *for the first time* that it has neither independent nor successor liability for any alleged [earplug]-related injuries.” [Emphasis in original.] She called the parent's new theory “a brazen abuse of the litigation process after 3M's nearly four years of affirmatively asserting, advocating, and wielding . . . the precise opposite position in the MDL.”

Judge Rodgers continued by recounting some of the instances in the MDL and in bellwether trials where the 3M parent declared its “exclusive responsibility for” earplug claims. The previous representations, she said, were “either knowingly false at the time or, instead, and much more likely the case, regrettable truths that became incompatible with their bankruptcy strategy.”

“Either way,” Judge Rodgers said, “3M's attempt to renege on those positions now, and its duplicitous motives and mode of doing so, are beyond the pale of acceptable litigation conduct and reflect a flagrant contempt for this Court and the MDL process.” The parent's “machinations,” she said, “have frustrated, manipulated, and delayed the fair, efficient, and effective resolution of hundreds of thousands of [earplug] claims.” The “abuses,” she said, “are the epitome of bad faith and deserve sanctions.”



Judge Rogers found “[o]nly one sanction . . . commensurate with the seriousness of that assault on the integrity of the MDL and this Court.” Reprimands and monetary sanctions, she said, “would fail to address the nature, purpose, and ramifications of 3M’s abuses.”

Rather than change strategy, Judge Rodgers said that the parent “had legitimate options.” One of them was to “[f]ile a petition for bankruptcy alongside its codefendants.” [Emphasis in original.]

As a sanction, Judge Rodgers precluded the parent from “attempting to avoid any portion of its alleged liability for the [earplug] claims” in any cases “currently filed in the MDL . . . and in all cases filed or transferred to the MDL in the future.”

Judge Rodgers ended her opinion by certifying an interlocutory appeal to the Eleventh Circuit and staying proceedings in the MDL pending the appeal. She urged the appeals court “to hear any appeal from this Order as soon as possible.

[The opinion is](#) *In re 3M Combat Arms Earplug Products Liability Litigation*, 19-2885 (N.D. Fla. Dec. 22, 2022).



Executory Contracts & Leases



Adequate assurance of future performance may not be required if the debtor has already cured the breach of lease, the Ninth Circuit says.

A Cured Breach Still Invokes Section 365(b)(1)'s Landlord Protections, Circuit Says

If there has ever been a breach of a lease of real property — even if it was cured or was not material — the landlord is still entitled to “adequate protection” or one of the other assurances laid out in Section 365(b)(1), according to the Ninth Circuit.

However, “adequate assurance” may not be required if the breach has been cured or if the debtor has agreed to comply with the lease by having assumed the lease, Circuit Judge Danielle J. Forrest said.

The Monetary and Nonmonetary Breaches of Lease

The debtor leased several floors of an office building in a large city. In her September 23 opinion, Judge Forrest said the lease was below-market.

The landlord and the tenant were not on good terms. Before the tenant’s bankruptcy, the landlord asked the tenant to sign an estoppel certificate to assist in refinancing. The tenant refused and instead said there were problems with the premises and that the tenant had claims against the landlord.

After the squabble about the estoppel certificate, and also before bankruptcy, the landlord notified the tenant about several alleged, non-monetary breaches of the lease. When the landlord threatened to terminate the lease, the tenant filed a chapter 11 petition.

In bankruptcy, the tenant paid a month’s rent into an escrow account, claiming a right to a Covid rent moratorium under local law. The bankruptcy court concluded that the moratorium did not apply. The tenant-debtor paid the rent late and subsequently paid a late fee charged by the landlord.

Soon after filing, the tenant moved to assume the lease. After a year’s discovery, the bankruptcy judge held a trial and allowed the tenant to assume the lease. Judge Forrest quoted the bankruptcy judge as finding that many of the alleged breaches “appeared manufactured, and minor, and made-up, sometimes.”



The landlord nonetheless sought “adequate protection” under Section 365(b)(1) because there had been a breach of lease. The bankruptcy judge decided that the landlord was not entitled to “adequate protection” because the breaches were cured or were not material and would not result in forfeiture of the lease under California law.

The district court affirmed. The landlord appealed to the circuit and won a pyrrhic victory. Although the landlord was entitled to the protections of Section 365(b)(1), the error was harmless because any monetary breach had been cured, and the debtor’s promise to abide by the lease covered everything else.

The Verb Tense in Section 365(b)(1) Is Pivotal

Judge Forrest paraphrased Section 365(b)(1) as saying that a debtor may assume an unexpired lease if (1) it cures or provides adequate assurance of curing a default, (2) provides compensation for actual pecuniary loss, and (3) provides “adequate assurance of future performance.”

However, the prelude in Section 365(b)(1) requires the three protections “[i]f there has been a default.” When there has been no default, “section 365(b)(1)’s requirements — cure, compensation and adequate assurance of future performance — are not triggered,” Judge Forrest said.

The tenant-debtor contended that no protection under Section 365(b)(1) was required because the bankruptcy court had found “no ongoing default at the time of assumption and . . . that any default that had occurred was immaterial under California law.”

Judge Forrest nixed the contention by reference to the “plain terms of the statute” and the use of the “present-perfect tense,” *i.e.*, if “there has been a default.” Citing the *Collier* treatise, she said that the “assertion that section 365(b)(1) can provide no relief for a landlord where a default already has been cured is simply incorrect both as a matter of interpretation and common sense.”

Judge Forrest held that the absence of an “active default . . . did not render section 365(b)(1)’s curative requirements inapplicable.”

Next, Judge Forrest dealt with the idea that the lack of a material default would render the section inapplicable. She found “no basis for this interpretation” and held that “the bankruptcy court erred in narrowly interpreting ‘default’ to refer only to defaults that are sufficiently material to warrant forfeiture of the lease under California law.”

Judge Forrest concluded the opinion by addressing “whether the bankruptcy court’s failure to analyze section 365(b)(1)’s curative requirements was reversible error” under F.R.C.P. 61, made applicable by Bankruptcy Rule 9005.



The only issue was the landlord’s claimed right to “adequate protection of future performance” under Section 365(b)(1)(C), because any existing breaches had been cured or had been found by the bankruptcy judge to be “only minor deviations from the contract terms.”

“Thus,” Judge Forrest said, “any adequate assurance responsive to the alleged defaults would be little more than simple promises not to deviate from the contract terms again.” She went on to say that the landlord “has not explained how any additional assurance of future performance would have substantively impacted its right to full performance of the lease terms.”

Judge Forrest held that any error by the bankruptcy court was “harmless.” Alluding to the below-market nature of the lease, she said that the landlord “made the deal” and “is not entitled to use section 365(b)(1) as a means to get out of a bad deal so that it can make a better one.”

[The opinion is](#) *Smart Capital Investments I LLC v. Hawkeye Entertainment LLC (In re Hawkeye Entertainment LLC)*, 21-56264 (9th Cir. Sept. 23, 2022).



Someone who is not a party to the contract being assumed can't assert a cure claim, even though Section 365(b) doesn't give the counterparty the sole right to demand a cure on assumption of an executory contract.

Second Circuit Holds: The Party to a Contract Alone May Assert a 'Cure Claim'

The Second Circuit held that no one aside from the counterparty to a contract can force the debtor to cure in conjunction with the assumption of an executory contract, upholding decisions by retired Bankruptcy Judge Shelley C. Chapman of New York and District Judge Jed S. Rakoff.

The appeal to the Second Circuit arose from the refurbishment of the bus terminal at the foot of the George Washington Bridge in northern Manhattan. The Port Authority of New York and New Jersey, the owner of the terminal, granted a 99-year ground lease to a developer in return for the developer's agreement to pay most construction costs.

The developer hired a general contractor. The ground lease explicitly said that the Port Authority had no obligation to pay the contractor.

In chapter 11, the developer arranged to assume and assign the assets, principally the ground lease. Claiming it was owed \$113 million by the developer, the general contractor objected to assumption and assignment of the lease unless the \$113 million default was "cured" under Section 365(b)(1)(A).

Indeed, the general contractor had a point. The \$113 million claim was a default under the developer's ground lease with the owner. So, the Port Authority waived the cure claim. The general contractor continued to object and claimed that it too had a right to demand cure.

Bankruptcy Judge Chapman overruled the general contractor's objection and approved the sale. District Judge Rakoff affirmed on appeal. *Tutor Perini Building Corp. v. New York City Regional Center George Washington Bridge Bus Station & Infrastructure Development Fund LLC (In re George Washington Bridge Bus Station Development Venture LLC)*, 20-7422, 2021 WL 3403590 (S.D.N.Y. Aug. 4, 2021). To read ABI's report on Judge Rakoff's affirmance, [click here](#).

Priority Claims Not Given Liberally



The general contractor appealed once more but was rebuffed in an April 10 opinion by Circuit Judge Eunice C. Lee. She framed the question as “whether [Section 365(b)(1)(A)] allows a creditor in [the general contractor’s] position to assert a ‘cure claim, which entitles a creditor to the highest priority of payment under the Bankruptcy Code, even if the creditor has no contractual rights in the contract or lease being assumed.”

The general contractor argued that the language of Section 365(b)(1)(A) does not limit who may have a cure claim. Judge Lee agreed, saying that the section “does not spell out which parties may raise a default in an assumed contract or lease to seek priority on their claims.”

Explaining that the general contractor would jump ahead of other unsecured creditors if it had a cure claim, Judge Lee cited authorities for the principle that statutory priorities are narrowly construed.

Judge Lee could “not see how it furthers any statutory purpose to read § 365(b) as granting administrative priority to someone whose claims against the debtor do not arise from a contract assumed under § 365(a).” Granting priority status as a consequence of a cure claim, she said, would allow the general contractor to “cut the line and stand in front of even secured creditors in exchange for nothing.”

Regarding the principal issue on appeal, Judge Lee held that a “creditor asserting a default must have some right to pursue a breach of contract claim under the executory contract” being assumed.

The contractor fared no better with an alternative argument that it was a third-party beneficiary under the ground lease. Judge Lee said that New York law generally requires express language in the contract stating that it was intended to benefit a third party.

There was no such language in the contract. Indeed, others were named as third-party beneficiaries, but not the general contractor. Judge Lee rejected the third-party beneficiary argument and affirmed the district court’s judgment.

The opinion is Tutor Perini Building Corp. v. New York City Regional Center George Washington Bridge Bus Station & Infrastructure Development Fund LLC (In re George Washington Bridge Bus Station Development Venture LLC), 21-2050 (2d Cir. April 10, 2023).



Bankruptcy Judge Michael Wiles differed with his colleagues who in previous years had employed the ‘time approach’ in calculating a landlord’s rejection damages under Section 502(b)(6).

For the Cap on Lease Rejection Claims, Judge in the SDNY Adopts the ‘Time Approach’

“The times they are a-changin.”

That’s what Bankruptcy Judge Michael E. Wiles of New York effectively said in his opinion recounting how the majority of courts have altered course and now calculate damages for termination of a lease using the so-called “time approach.” In his February 2 opinion, Judge Wiles differed with colleagues on the New York bench who had followed the so-called “rent approach” in decisions in 1999 and 2011.

The decision by Judge Wiles disfavors landlords, because the time approach yields lower claims in cases where the rent increases over the life of a long-term lease.

Asserting the time approach, the plan administrator objected to claims of landlords whose leases had terminated. The landlords wanted the rent approach.

The outcome turned on the language in Section 502(b)(6)(A), italicized below, which limits a claim for termination of a lease to “the rent reserved by such lease, without acceleration, *for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease*, following the earlier of — (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; . . .” [Emphasis added.]

Basically, the time approach calculates the rent that would have been owing for the first 15% of the remaining term of the lease following termination. The rent approach calculates 15% of the rent that would have been owing during the remaining term of the lease.

In leases where rent escalates over the years, the rent over the remaining term of the lease would be higher than the rent owing in the period of time following termination.

Judge Wiles found two cases in the Southern District of New York, both invoking the rent approach. The most recent opinion was in 2011.



Since the 2011 decision, Judge Wiles said that “the weight of the relevant authorities in other districts has shifted very strongly in favor of the Time Approach.” Indeed, he said, “All of the reported decisions that we have found that have addressed this issue since the beginning of 2012 have concluded that the Time Approach is the correct one.”

Judge Wiles also noted that the *Collier* treatise flopped from one camp to the other and advocated the time approach in 2015.

Saying he did “not lightly depart from prior precedent in this District,” Judge Wiles said he was “convinced that the Time Approach represents the correct view.”

First and foremost, Judge Wiles found the answer in the “plain language of the statute.” The “entire phrase,” he said, “is worded in terms of periods of time.” If the drafters had intended to apply the rent approach, he said that Section 502(b)(6) would have referred to “15 percent of the rent reserved for the remaining term of such lease”

Judge Wiles also said that the time approach “finds strong approach in the legislative history.” He held that the

claims are to be calculated by reference to the rents reserved under the relevant leases for the first 15% of the remaining lease terms, *provided* that such amounts shall not be less than the rents reserved for the first remaining year of the relevant lease terms, and shall not be greater than the rents reserved for the first three remaining years of the relevant lease terms.

Other Holdings of Note

The trustee and the landlords had other disagreements about damage calculation. For instance, was the cost to clean up the property subject to the cap?

Judge Wiles adopted the approach in *Saddleback Valley Cmty. Church v. El Toro Materials Co.* (*In re El Toro Materials Co.*), 504 F.3d 978 (9th Cir. 2007), where the Ninth Circuit asked whether the landlord would have the same claim had the lease been assumed.

In the case before him, the leases called for the tenant on termination to leave the premises “broom clean” and “in good order.” Therefore, cleanup costs arose from the termination and would be subject to the cap, because the landlord would not have had the claim were the lease assumed.

For mechanics’ liens, the result was otherwise.

The debtor had failed to pay contractors who filed mechanics’ liens against the properties. Under the leases, the debtor would have been required to pay off the liens. The landlords’ claims



to pay off the liens were not subject to the cap because they “would have existed regardless of whether the lease was terminated.”

Similarly, the landlords’ claims to repair windows and the façade were not subject to the cap, because the claims would have belonged to the landlord if there were no termination.

[The opinion is](#) *In re Cortlandt Liquidating LLC*, 20-12097 (Bankr. S.D.N.Y. Feb. 2, 2023).



Because a limited partner's obligations were only 'options,' the partnership agreement was not an executory contract, Chief Judge Meier says.

Limited Partnership Agreement Is an Estate Asset, Not an Executory Contract

An individual bankrupt's interest in a limited partnership is akin to an option and isn't an executory contract subject to automatic rejection 60 days after filing, according to Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho.

On filing in chapter 7, the debtor had a 10.5% interest in a limited partnership. The partnership agreement gave the debtor the right to request distributions from the partnership to cover the debtor's tax liabilities arising from the debtor's share of partnership income. The agreement also gave other partners a right of first refusal if a partner were to sell his or her partnership interest voluntarily or involuntarily.

The trustee did not move to assume the partnership agreement within 60 days of filing in 2016. More than 60 days after filing, the trustee did request and did receive distributions from the partnership to cover taxes for the years 2017 and 2018.

For 2019, however, the partnership refused to honor the trustee's request for a tax distribution. The trustee filed a complaint in bankruptcy court seeking a declaration that the partnership interest was property of the estate and that the trustee was entitled to tax distributions.

The trustee moved for partial summary judgment to declare that the partnership interest was not an executory contract that was automatically rejected 60 days after filing under Section 365(d)(1). Naturally, the partnership took the position that it was an automatically rejected executory contract, leaving the trustee with nothing to sell.

In his February 24 opinion, Judge Meier addressed the question of whether the partnership interest was an executory contract under the so-called Countryman definition. The late Harvard Law School Professor Vern Countryman defined a contract as executory if the obligations of both parties are so far unperformed that a failure by either to complete performance would constitute a material breach excusing performance by the other.

The Right to Distributions



Employing the Countryman test, Judge Meier examined the outstanding obligations of the debtor on the filing date.

Judge Meier said that the right to receive tax distributions “is akin to an option” and that an option is the “grant of a right without any obligation.”

Judge Meier found controlling Ninth Circuit authority in *Unsecured Creditors Comm. Of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)*, 139 F.3d 702, 705 (9th Cir. 1998) (*en banc*). In *Helms*, the Ninth Circuit sat *en banc* to overrule the circuit’s prior authority, which had held that all options are executory.

Helms said that performance “due only if the optionee chooses at his discretion to exercise the option doesn’t count unless he has chosen to exercise it.” Typically, the appeals court said, the optionee has breached no material obligations “by doing nothing,” that is, by not exercising the option.

Judge Meier interpreted *Helms* to mean “that an option is non-executory if the optionee need not exercise the option, and if he does nothing, the option lapses without breach.” In the case before him, Judge Meier said that a partner’s failure to exercise the option meant that the option lapsed without breach.

Definitionally speaking, Judge Meier held that the option to take down distributions did not make the agreement executory.

The Right of First Refusal

The partnership argued that the right of first refusal made the agreement executory.

Reasoning that the failure to exercise a right of first refusal would not breach a performance obligation, Judge Meier held that the first refusal provision did not render the agreement executory.

The Partnership’s Defenses

The partnership offered several defenses, none of which persuaded Judge Meier.

Even if the partnership agreement was a personal services contract under Section 365(c), it didn’t matter because the contract was not executory.

The partnership argued for executory treatment because the state Uniform Partnership Act imposes obligations of good faith and fair dealing. Judge Meier could not “fathom” how a statutory requirement could “singlehandedly” make the contract executory. If it were so, he said, “all contracts would be executory.”



Estoppel didn't preclude the trustee's motion, Judge Meier said, because the trustee had not falsely concealed a material fact. Likewise, quasi-estoppel didn't apply because it was not unconscionable for the trustee to say the agreement was not executory when the partnership had honored distribution requests long after the 60-day window for assumption had passed.

There was no judicial estoppel because the trustee had not changed positions, and there was no waiver because the trustee had previously requested distributions.

Judge Meier granted summary judgment to the extent of declaring that the agreement was valid and enforceable to the extent that it was not executory.

"As to any other reason the Agreement may not be valid or enforceable as to the estate's interest," Judge Meier said it "would be a separate issue which is not presently before the Court." He left open the question of whether the trustee could sell, assume or assign the limited partnership interest.

Observations

Prof. Jay L. Westbrook told ABI that the "Countryman test has greatest difficulties with unilateral contracts like options because failure of the option holder to exercise is almost never a material breach, yet an option, of course, can be of great value, so any trustee would want to assume."

In his seminal article about executory contracts in 2017, Prof. Westbrook said about limited partnerships that "the material breach test rarely arrives at the right question because the analysis gets lost on the 'executoriness' detour." *See* Prof. Jay L. Westbrook and Kelsi S. White, "[The Demystification of Contracts in Bankruptcy](#)," 91 *Am. Bankr. L.J.* 481 (Summer 2017). Prof. Westbrook occupies the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law.

In his article, Prof. Westbrook said that "it is easy to get lost trying to determine whether LLC agreements meet the material breach test for executoriness." Citing "irreconcilable precedents," he said that "courts are currently wrestling with that question."

Under the "functional analysis" proposed in his article, Prof. Westbrook said that "this entire debate can be sidestepped because it is clear that any LLC agreement has at least some remaining obligations rendering it 'executory' under the common law definition of the word."

Using the professor's approach, a limited partnership agreement would be an executory contract if there were either obligations the trustee would wish to avoid or value that the trustee would wish to collect for creditors. In the case before Judge Meier, the partnership agreement



would be executory under Prof. Westbrook's approach because there obviously was value in the right to claim distributions and, presumably, also in selling the limited partnership interest.

Prof. Westbrook points out in his article how some courts view limited partnership agreements not as contracts but as assets to be handled under Section 541. With respect to those courts that see partnership agreements as assets, this writer would observe that partnership agreements confer contractual rights on limited partners and therefore resemble contracts. Whether those obligations are material under the Countryman test is another question.

A limited partnership is a hybrid creature not easily pigeonholed. It is akin to the ownership of stock in an ordinary corporation, in that the owner has no personal liability for the corporation's debts. On the other hand, limited partners have rights with respect to the corporation not enjoyed by ordinary stockholders.

A limited partnership interest perhaps more resembles preferred stock. Neither common nor preferred stock is rejectable. As assets that are not contracts, stock can be abandoned or sold with no 60-day limitation for assumption or rejection.

Limited partnership agreements more resemble contracts than stock. If rights and obligations have not been fully performed, why does it matter if they remain only on one side? If a right or an obligation has economic consequences to assume or avoid, why does it matter if they are unilateral?

Courts' approaches to executory contracts are evolving. In a recent opinion on surety bonds, for instance, the Fifth Circuit said that courts should not foreclose the use of the functional analysis when confronting multiparty contracts. *Argonaut Ins. Co. v. Falcon V LLC (In re Falcon V LLC)*, 44 F.4th 348, 355 at fn. 9 (5th Cir. Aug. 11, 2022). To read ABI's report, [click here](#).

The bottom line is this: If the court applies the Countryman definition, a limited partnership interest might not be an executory contract. If a court were to employ Prof. Westbrook's functional analysis, the partnership interest might be executory. Or, a partnership interest might be some peculiar sort of an asset.

Keep in mind that a court employing Prof. Westbrook's analysis could rule that a partnership interest was rejected automatically if it was not assumed in a timely manner.

Given the confusion about limited partnerships, a trustee or a debtor at the outset of a case should determine whether the partnership interest has value or whether there are onerous obligations. Even if the particular judge sitting on the case has taken a position elsewhere, the trustee should ask the court proactively to decide whether or not the partnership agreement is executory or is another sort of an asset.



The nature of a partnership interest isn't likely to be resolved soon. And limited partnership agreements are not uniform, so the result in one case might not control in another.

Consequently, a trustee should quickly decide whether to assume, reject, sell, assign or abandon a partnership interest. On the other side of the coin, the limited partnership should move for a declaration that the executory contract was automatically rejected after 60 days or to compel the debtor to abandon the asset.

[The opinion is](#) *Rainsdon v. Duncan LP (In re Duncan)*, 20-8056 (Bankr. D. Idaho Feb. 24, 2023).



Venue, Jurisdiction & Power



Even if an appeal is equitably moot, the appellate court nonetheless has appellate jurisdiction. Equitable mootness is prudential, not jurisdictional.

Courts May Bypass Equitable Mootness to Rule on the Merits, Fifth Circuit Says

When equitable mootness is a close question on appeal, the Fifth Circuit has ruled that an appellate court can bypass a motion to dismiss for equitable mootness and address the appeal on the merits.

Why is that so? Because an appellate court does not lack constitutional or Article III jurisdiction, even if the appeal is equitably moot.

The debtor operated a gasoline station and claimed to have an unperformed contract to buy the property from the owner. Finding there was no enforceable contract, the bankruptcy court denied the debtor's motion to compel the owner to sell the property to the debtor. The debtor appealed.

While the appeal was pending in district court, the bankruptcy court dismissed the underlying case. After losing in district court, the debtor appealed to the Fifth Circuit.

For the first time in the court of appeals, the property owner claimed that the appeal was equitably moot because the underlying case had been dismissed. Even if denial of the motion to sell were to be reversed on appeal, the owner reasoned that the appeal was equitably moot because the bankruptcy court could not compel the owner to sell the property.

The debtor contended that there was still a live controversy, since the debtor and the owner disagreed about the enforceability of the contract regardless of the status of the bankruptcy case.

In his opinion on May 3, Circuit Judge Stephen A. Higginson first addressed equitable mootness. Citing *In re Pac. Lumber Co.*, 584 F.3d 229, 240 (5th Cir. 2009), he described equitable mootness as a judicially created version of appellate abstention that favors finality in reorganizations and protects multi-party expectations.

The property owner submitted that dismissal of the bankruptcy case was similar to consummation of a chapter 11 plan, thus foreclosing appellate relief. The debtor countered by saying that equitable mootness did not apply because the enforceability of the contract was ancillary to the bankruptcy and was still a live controversy.



In the Fifth Circuit, the owner conceded that enforceability of the contract remained a live controversy and that the debtor retained an interest in the outcome of the dispute.

Judge Higginson therefore characterized the owner as contending that the case was equitably moot because there could be no effective relief, even though there was a live controversy.

“Resolution of this dispute raises unsettled questions in bankruptcy law,” Judge Higginson said. However, he cited the Third, Fifth and Seventh Circuits for having bypassed equitable mootness to rule on the merits. In particular, he cited then-Circuit Judge Samuel A. Alito, Jr. for having said in dissent that equitable mootness does not present a question of jurisdiction to resolve before reaching the merits. *In re Continental Airlines*, 91 F.3d 553, 568–72 (3d Cir. 1996) (*en banc*).

Judge Higginson decided to “leave those issues for another day” because he could affirm on the merits.

On the merits, Judge Higginson upheld denial of the motion to compel sale, because the “brief email exchange did not demonstrate an offer or acceptance, as required for a contract to be binding under Texas law.”

Questions for Our Readers

Here are some questions for our readers to answer:

1. Begin with the assumption that the appellate court has constitutional or Article III jurisdiction because there was a live dispute between the parties regarding enforceability of the contract. Further assume that the appellate court reverses by finding there was an enforceable contract. On remand, would the bankruptcy court have jurisdiction?
2. Given that the underlying case had been dismissed and the bankruptcy court could not compel the owner to sell, would the parties be asking the bankruptcy judge to give an advisory opinion?
3. If a trial court is being asked to give an advisory opinion, does the trial court nevertheless possess Article III or constitutional jurisdiction? Would there be no constitutional jurisdiction because there was no “live” controversy at the time?
4. Had the Fifth Circuit drilled down deeper, would there have been no Article III jurisdiction given the constraints on what the trial could do on remand?

[The opinion is](#) *Texxon Petrochemicals LLC v. Getty Leasing Inc. (In re Texxon Petrochemicals LLC)*, 22-40537 (5th Cir. May 3, 2023).



Ninth Circuit says that the 'person aggrieved' standard for appellate standing was superseded by Article III standing on adoption of the Bankruptcy Code in 1978.

'Person Aggrieved' Isn't the Proper Standard for Bankruptcy Appeals, Circuit Says

If injury to the appellant is “too conjectural and hypothetical,” the Ninth Circuit says there is no appellate standing, even under the less demanding standard for Article III or constitutional standing as opposed to the more exacting “person aggrieved” test.

In his May 8 opinion, Circuit Judge Ryan D. Nelson dismissed the appeal because the chapter 11 plan promised full payment to the appealing creditor. Although the debtor was behind in making plan payments, the injury remained “conjectural at best,” given the effusive findings of fact by the bankruptcy court assuring payment in full.

Note: Judge Ryan Nelson is not to be confused with Senior Circuit Judge Dorothy W. Nelson, also of the Ninth Circuit.

The Full Payment Plan

The chapter 11 debtor confirmed a plan promising payment in full, with interest, to unsecured creditors, even to creditors whose claims were subordinated. To assure full payment, the plan was backstopped with a \$10 million contribution by a plan proponent. In addition, creditors were given collateral security in the form of a lien on all assets.

Bankruptcy Judge Sheri Bluebond of Los Angeles found that the debtor was emerging from chapter 11 with \$23.4 million in net equity in its assets. Judge Nelson said the net equity “far” exceeded the claims to be paid under the plan.

The debtor had been under the command of a chapter 11 trustee. After confirmation, the trustee filed an application for payment of about \$1.16 million in compensation, the maximum commission under Section 326(a).

The requested compensation represented about \$760,000 at the trustee’s usual hourly rate of \$450 per hour. The trustee justified the additional \$400,000 as an enhancement for “exceptional services.”



Bankruptcy Judge Bluebond granted the requested compensation in full, saying that the commission in itself was presumptively reasonable and that the results of the reorganization were exceptional, justifying enhancement over the lodestar.

A subordinated creditor appealed the allowance of the trustee's compensation. The district court held that the creditor was an "aggrieved party" given the possibility of it not being paid in full. On the merits, however, the district court affirmed the award.

The subordinated creditor appealed to the circuit.

The Critique of 'Person Aggrieved'

For appellate jurisdiction, Article III of the Constitution requires the existence of a case or controversy. Judge Nelson said that appellate courts have been imposing the higher "person aggrieved" standard to justify appellate standing in bankruptcy cases.

Judge Nelson's opinion is a lesson in history. He explained how "person aggrieved" was a "prudential requirement" found in the Bankruptcy Act of 1898. It was adopted to restrict appeals to those who would be affected by the outcome.

Although the Bankruptcy Act was repealed in 1978 on adoption of the Bankruptcy Code, Judge Nelson said, "we continued to apply the 'person aggrieved' standard." Moreover, he said:

It is unclear why we continued to apply the person aggrieved rule in the absence of the statute providing the basis for doing so. We appear to have recast the pre-1978 statutory standard and applied it as a principle of prudential standing.

"But," Judge Nelson said, "the Supreme Court has since questioned prudential standing," finding tension with federal courts' "virtually unflagging" obligation to hear cases within their jurisdictions. *See Susan B. Anthony List v. Dreihaus*, 573 U.S. 149, 167 (2014).

"Still," Judge Nelson said, "our bankruptcy cases have historically addressed prudential standing with little attention to Article III."

No Article III Appellate Jurisdiction

Judge Nelson examined the facts to determine whether the subordinated creditor had Article III standing. The required showing is (1) an "injury in fact" that is concrete, particularized and actual or imminent; (2) an injury "fairly traceable" to the defendant's conduct; and (3) an injury that can be addressed by a favorable decision. The "foremost" requirement is injury in fact, Judge Nelson said.



The subordinated creditor claimed injury because it had not yet been paid in full, and the extra compensation for the trustee diminished the likelihood of full payment. The debtor countered by saying there was no harm because the creditor would be paid in full, the only question being when or how soon.

Judge Nelson examined the plan and the facts in detail. He noted that the plan did not have a limited fund because there was “no finite amount of assets from which all creditors could be paid.” Indeed, he said there was a 35% equity cushion protecting the payment of claims in full.

Given that payment in full was assured, Judge Nelson said in substance that any delay in payment would not give rise to injury. He held that the creditor’s “alleged injury is too conjectural and hypothetical to establish injury in fact for Article III standing.

Judge Nelson reversed the district court and remanded with instructions to dismiss the appeal for lack of appellate standing.

Equitable Mootness

Judge Nelson’s opinion is another indication that the doctrine of equitable mootness would not withstand scrutiny in the Supreme Court.

When a consummated chapter 11 plan is found to be equitably moot, there is typically a case or controversy establishing Article III or constitutional jurisdiction in the appellate court, because the parties disagree about the legal principle underlying the appeal. Equitable mootness is a higher, judge-made standard employed by appellate courts to dismiss appeals when the appellate court nonetheless has jurisdiction.

Judge Nelson’s opinion recites the Supreme Court’s admonition that courts are obliged to exercise their jurisdiction.

Weaving the notions together, the Supreme Court one day might say that appellate courts must resolve the case or controversy arising from disputed confirmation and remand for the bankruptcy court to identify relief that is available, if any.

[The opinion is](#) *Clifton Capital Group LLC v. Sharp (In re East Coast Foods Inc.)*, 21-55967 (9th Cir. May 8, 2023).



The Fifth Circuit declined to follow the Ninth Circuit in questioning ‘person aggrieved’ as being inconsistent with recent Supreme Court authority.

Fifth Circuit Reaffirms ‘Person Aggrieved’ as the Standard for Appellate Standing

Where the Ninth Circuit recently questioned whether the “person aggrieved” standard for appellate standing is still good law, the Fifth Circuit reaffirmed the standard, saying that the Supreme Court had only nixed a more demanding prudential standing requirement in cases under the Lanham Act.

After confirmation of a chapter 11 plan, Bankruptcy Judge Stacey G. C. Jernigan of Dallas held a hearing on final allowances of compensation to five professional firms that had served the debtor and the official committee. Alleging to be a creditor by virtue of a disputed administrative claim, the creditor objected to the allowances. The creditor may have been motivated to object because it was a defendant in a pending adversary proceeding.

Bankruptcy Judge Jernigan overruled the objection and granted the allowances. The alleged creditor appealed.

Invoking the “person aggrieved” standard, the district court dismissed the appeal. The alleged creditor appealed to the Fifth Circuit.

In his July 19 opinion, Circuit Judge Patrick E. Higginbotham noted that the bankruptcy court had dismissed the creditor’s alleged administrative claim while the appeals were pending on the fee allowances.

‘Person Aggrieved’ Survives

Judge Higginbotham opened his discussion of the merits by noting how “person aggrieved” was the standard for appellate standing set forth in Section 67(c) of the former Bankruptcy Act. The Act was repealed on adoption of the Bankruptcy Code, but the “person aggrieved” requirement was contained in neither the Code nor Title 28.

“Person aggrieved” requires that the appellant be directly and adversely affected pecuniarily, Judge Higginbotham said. “Person aggrieved” is “more exacting,” he said, because it demands a higher causal relationship between the act and the injury than the more flexible Article III standard, known as constitutional standing.

Judge Higginbotham quoted a 2018 Fifth Circuit decision to explain why appellate standing is necessarily more demanding in bankruptcy cases, even after adoption of the Bankruptcy Code:



Allowing each and every party to appeal each and every order would clog up the system and bog down the courts. Given the specter of such sclerotic litigation, standing to appeal a bankruptcy court order is, of necessity, quite limited.

In re Technicool Sys., Inc. (In re Technicool), 896 F.3d 382, 385 (5th Cir. 2018).

The Merits

Having established that “person aggrieved” survived, Judge Higginbotham examined whether the alleged creditor was aggrieved.

Even if the creditor had an administrative claim, Judge Higginbotham said that the possibility of not being paid was “too remote or speculative” to confer standing. Furthermore, disallowance of the creditor’s administrative claim “takes the legs” out from underneath the argument, he said.

The creditor also contended that status as a defendant in an adversary proceeding conferred standing. Judge Higginbotham said that “no less than” seven outcomes would be required before allowance of the fees would “impact” the creditor-defendant.

Having failed to show standing under “person aggrieved,” the creditor contended that the standard “did not survive” *Lexmark Int’l, Inc. v. Static Control Components, Inc.* 572 U.S. 118 (2014), where the Supreme Court dealt with standing under the Lanham Act.

The creditor argued that *Lexmark* precludes courts from adopting prudential rules on standing that are stricter than Article III standing.

Judge Higginbotham said that *Lexmark*, which was not a bankruptcy case, did not “unequivocally” overrule Fifth Circuit precedent such as *Technicool*. Even after *Lexmark*, he said that the Fifth Circuit “has repeatedly reaffirmed the ‘person aggrieved’ standard.”

The creditor cited the Ninth Circuit for having abandoned “person aggrieved” in May. See *Clifton Capital Group LLC v. Sharp (In re East Coast Foods Inc.)*, 66 F.4th 1214 (9th Cir. May 8, 2023). To read ABI’s report, [click here](#). Judge Higginbotham said that *East Coast Foods* “is not offended by the more exacting ‘person aggrieved’ metric attending the disposition of bankruptcy claims like the one at issue.”

Finally, the creditor argued that it had standing under Section 1109(b), which says:

A party in interest, including the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.



Judge Higginbotham said that Section 1109(b) “speaks to one’s standing to appear and be heard before the bankruptcy court, a concept distinct from standing to appeal the merits of a decision.” He cited the *Collier* treatise for saying that “person aggrieved” is the standard for appellate standing, not Section 1109(b).

Judge Higginbotham affirmed the district court for having dismissed the appeal for lack of appellate standing.

[The opinion is](#) *NexPoint Advisors LP v. Pachulski Stang Ziehl & Jones LLP (In re Highland Capital Management LP)*, 22-10575 (5th Cir. July 19, 2023).



*Foreign creditors not subject to
'specific personal jurisdiction' in the U.S.
can violate the automatic stay with
impunity.*

Seventh Circuit Limits a U.S. Court's Jurisdiction over Creditors Abroad

While U.S. bankruptcy courts are reorganizing large companies headquartered and operating chiefly abroad, the Seventh Circuit laid down rules barring U.S. bankruptcy courts from stopping foreign creditors from taking action against a debtor's assets abroad when the U.S. court has no general or specific personal jurisdiction over the creditors.

The debtor was a U.S. citizen who borrowed money from a bank in Ireland to purchase stock in an Irish company and real property in Ireland. The debtor gave the bank a lien on the stock and real property to secure the loan.

After the debtor defaulted on the loan, the bank sold the loan to an Irish purchaser, whom we shall call the creditor. The creditor began foreclosure proceedings in Ireland. After lengthy litigation, the Irish court appointed an Irish receiver to take possession and sell the stock and the real property.

Before the receiver sold the collateral, the debtor filed a chapter 11 petition in Chicago, notified the creditor and the receiver about the bankruptcy, and demanded that the receiver return possession of the property to the debtor. The creditor and the debtor declined.

So, the debtor filed an adversary proceeding in the Chicago bankruptcy court, contending that the creditor and the receiver were violating the automatic stay. The debtor wanted the bankruptcy court to return possession of the collateral to the debtor.

The receiver and the creditor filed a motion to dismiss for lack of personal jurisdiction. The bankruptcy court granted the motion, and the district court agreed that the bankruptcy court lacked personal jurisdiction over the receiver and the creditor. The debtor appealed to the circuit.

In an opinion on September 7, Circuit Judge Ilana Rovner affirmed.

The appeal was measured against the demands of due process that a defendant from elsewhere must have minimum contacts with the forum and that maintenance of the suit must not offend notions of fair play and substantial justice.



Neither the receiver nor the creditor had any connections with Illinois, but the debtor contended that the bankruptcy court's *in rem* jurisdiction over the collateral conferred personal jurisdiction over the defendants.

The debtor's argument went nowhere. Judge Rovner conceded that the U.S. court had jurisdiction over the property in Ireland, but she said that a U.S. bankruptcy court cannot enforce the stay abroad unless the court has personal jurisdiction over the party holding the property.

Next, the debtor tried a legal fiction: The debtor's property abroad is subject to the legal fiction of being located in Illinois. Based on the fiction, the debtor contended that the actions by the receiver and the creditor "must have occurred (fictionally) in Illinois," Judge Rovner said.

Judge Rovner saw no authority for the idea "linking personal jurisdiction to *in rem* jurisdiction." Instead, she said the court must have either general or specific personal jurisdiction over the party. The debtor admitted that there was no general jurisdiction over the defendants, who were Irish citizens and conducted business in Ireland.

So, Judge Rovner turned to specific personal jurisdiction. She said it requires that the defendants must have "purposefully directed their actions at the forum state" and that the alleged injury must have arisen from forum-state activities. In addition, the exercise of jurisdiction must comport with notions of fair play and substantial justice.

Granted, the defendants had contacts with the debtor, but "the defendants' minimum contacts must be with the forum itself and not merely with a person who resides there," Judge Rovner said. Similarly, she said, the "focus on a defendant's activities means that it is not enough that the defendant took some action that ultimately had an effect on the plaintiff in the forum."

Focusing on the facts, Judge Rovner said that the "Irish defendants directed their activity at Irish property located in Ireland and which served as collateral for a loan made by an Irish bank . . . None of the defendants did anything to reach out to the United States and affiliate themselves with the United States or Illinois." She said that specific personal jurisdiction "cannot be based on the plaintiff's mere presence in the forum or on the 'unilateral activity' of a plaintiff."

Likewise, Judge Rovner said, "the fact that the defendants could have foreseen that their conduct would affect [the debtor] in Illinois was insufficient to establish personal jurisdiction."

Concluding that the creditor and the receiver had no minimum contacts with the U.S., Judge Rovner upheld dismissal and therefore had no reason to decide whether exercising personal jurisdiction would violate notions of fair play and substantial justice.

[The opinion is](#) *Sheehan v. Breccia Unlimited Co. (In re Sheehan)*, 21-2946 (7th Cir. Sept. 9, 2022).



The Bankruptcy Rules for serving a summons and complaint are not jurisdictional, Eighth Circuit says.

Strict Rule Compliance Not Required for Serving a Complaint, Circuit Says

Strict compliance with Bankruptcy Rule 7004(b)(3) is not required for a complaint to be served effectively, for reasons explained by the Eighth Circuit in an opinion relying in part on the Supreme Court's *Espinosa* decision.

A creditor filed a proof of claim, listing its address and suite number in an office building, together with the name of a “managing partner.” Later, the chapter 7 trustee initiated a preference action by serving a summons and complaint on the creditor at exactly the address and suite number shown in the proof of claim. The trustee also put the name of the managing partner on the envelope, which was sent by certified mail, return receipt requested.

Before mailing the papers, the trustee checked with the secretary of state, learning that the creditor’s street address and suite number were exactly the same as the creditor had shown on the proof of claim. However, the secretary of state did not have the name of an authorized agent.

The return receipt came back signed, not by the managing partner but by an employee of the creditor who was not authorized to accept service of process.

The creditor never responded to the complaint. Following proper procedures, including additional notices to the creditor, the bankruptcy court eventually entered a \$150,000 judgment by default in favor of the trustee.

Finally awakening after service of the default judgment, the creditor filed a motion to vacate the judgment under Federal Rules 60(b)(4) and (b)(6). The creditor argued that service was invalid and the judgment was void because the creditor had moved to another floor in the same office building before the papers were served. The managing partner had also left the company before the trustee served the papers.

The creditor had failed to update its address with the bankruptcy court and the secretary of state, Circuit Judge James B. Loken said in his December 8 opinion.

The bankruptcy court denied the Rule 60(b) motion, and the district court affirmed. So did Judge Loken.



The principal governing authorities were Bankruptcy Rule 7004(b)(3), Federal Rules 60(b)(4) and (b)(6) and *United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260 (2010). Regarding the service of a summons and complaint on a domestic corporation, Rule 7004(b)(4) calls for:

mailing a copy of the summons and complaint to the attention of an officer, a managing or general agent, or to any other agent authorized by appointment or by law to receive service of process and, if the agent is one authorized by statute to receive service and the statute so requires, by also mailing a copy to the defendant.

Made applicable by Bankruptcy Rule 9024, Rule 60(b) governs vacating a judgment. Specifically, Rule 60(b)(4) will vacate a judgment if “the judgment is void.” The creditor submitted that the judgment was void because Rule 7004(b)(3) requires “strict compliance,” and the papers were served on the wrong person and at the wrong address.

Judge Loken said that his circuit has never required “strict compliance.” Rather, he said, the outcome is governed by *Espinosa*.

Judge Loken quoted *Espinosa* for the proposition that a judgment is void under Rule 60(b)(4) if it was based on “a jurisdictional error or on a violation of due process that deprives a party of notice or the opportunity to be heard . . .” *Espinosa, supra*, 559 U.S. at 270-271. He went on to quote *Espinosa* for saying that the rule is “generally . . . reserved” only for the “exceptional case” where there was no “arguable basis” for jurisdiction. *Id.*

Like the two lower courts, Judge Loken ruled that the bankruptcy court “at least” had an arguable basis for jurisdiction. The trustee had sent the papers to exactly the address on the creditor’s claim, and the papers were “*actually received*” by an employee of the creditor. [Emphasis in original.]

Furthermore, *Espinosa* says that procedural rules like Rule 7004 are not jurisdictional. Thus, the creditor was not entitled to void the judgment under Rule 60(b)(4).

Similarly, the creditor was not entitled to relief under Rule 60(b)(6), the so-called catchall that can be invoked for “any other reason that justifies relief.”

To begin with, Judge Loken said that Rule 60(b)(4) was not inapplicable. Because the creditor had failed to show “exceptional circumstances,” he affirmed the judgment given that the creditor was not entitled to relief under Rule 60(b)(4) an (b)(6).

[The opinion is](#) *PIRS Capital LLC v. Williams*, 22-1723 (8th Cir. Dec. 8, 2022).



The court's ability to compel trial testimony by video doesn't eradicate the 100-mile limitation on issuance of trial subpoenas.

Ninth Circuit: Trial Subpoenas Can't Compel Zoom Testimony More than 100 Miles Away

The Ninth Circuit used a bankruptcy case to grant a writ of mandamus and quash a subpoena that would have compelled a witness to testify at trial via contemporaneous video transmission from the witness's home, more than 100 miles from the location of the trial.

In short, the Ninth Circuit won't permit a trial court to use Federal Rule 43(a) to subvert the 100-mile limitation in Federal Rule 45(c)(1). In other words, a subpoena cannot compel a witness to appear and testify at trial via Zoom from a location more than 100 miles from the courthouse.

In her July 27 opinion, Circuit Judge Danielle J. Forrest said it was a "novel issue" that pitted two Federal Rules against one another and has divided the lower courts. The Ninth Circuit, she said, has "not previously addressed the application of Rule 45(c)'s geographical limitations to testimony provided via remote video transmission, which is a question of increasing import given the recent proliferation of such technology in judicial proceedings."

The Remote Witness

The trustee contended that a potential witness was the source of indispensable testimony to support the trustee's claim in an adversary proceeding pending in bankruptcy court in Los Angeles. The witness lived in the Virgin Islands and refused to appear voluntarily at trial in Los Angeles.

The bankruptcy court authorized the trustee to serve a trial subpoena by certified mail commanding the witness to testify remotely from the Virgin Islands by video transmission. The bankruptcy court denied the witness's motion to quash the subpoena.

The witness moved the bankruptcy court to certify an interlocutory appeal to the district court or the circuit court. The bankruptcy court denied the motion. The witness then filed a petition for mandamus, asking the Ninth Circuit to direct the bankruptcy court to quash the subpoena.

Mandamus Granted

Judge Forrest granted the petition in an opinion concluding that the 100-mile limitation in Rule 45(c) controls, not Rule 43(a).



Rule 54(c)(1) provides:

A subpoena may command a person to attend a trial, hearing, or deposition only as follows: (A) within 100 miles of where the person resides, is employed, or regularly transacts business in person.

The second sentence in Rule 43(a) says:

For good cause in compelling circumstances and with appropriate safeguards, the court may permit testimony in open court by contemporaneous transmission from a different location.

The trustee contended that “compelling circumstances,” such as the indispensability of the witness, can justify taking testimony “by contemporaneous transmission from a different location,” namely, the witness’s home in the Virgin Islands.

Before deciding whether Rule 43(a) would permit trial testimony remotely, Judge Forrest laid out the requirements for the issuance of a writ of mandamus, which she called an “extraordinary remedy” that only issues in exceptional circumstances amounting to judicial usurpation of power or a clear abuse of discretion. The writ, she said, “can be appropriate to resolve novel and important procedural issues.”

In the Ninth Circuit, five factors govern the issuance of the writ. *See Bauman v. U.S. Dist. Ct.*, 557 F.2d 650, 654–55 (9th Cir. 1977). The most pertinent for the appeal was the third factor: whether the district court’s order was clearly erroneous. Under the differential standard of clear error, Judge Forrest framed the question as “whether Federal Rule of Civil Procedure 45(c)’s 100-mile limitation applies when a witness is permitted to testify by contemporaneous video transmission.”

Focusing on Rule 45(c)(1)(A), Judge Forrest said that “the plain meaning of this rule is clear: a person cannot be required to attend a trial or hearing that is located more than 100 miles from their residence, place of employment, or where they regularly conduct in-person business.” She said that Bankruptcy Rule 7004(d) incorporates the same limitation.

“Thus,” Judge Forrest said:

we have no difficulty concluding that the [witness] could not be compelled to testify *in person* at a trial in California. The question here is how Rule 45(c) applies when a person is commanded to testify at trial *remotely*. [Emphasis in original.]



The trustee contended that Rule 43(a) circumvents the 100-mile limitation when the testimony is remote because remote testimony moves the “place of compliance” to wherever the witness is located.

To decide which rule dominates, Judge Forrest said that “determining the limits of the court’s power to compel testimony precedes any determination about the mechanics of how such testimony is presented.”

Consulting the advisory committee notes and drawing an analogy from Rule 32(a)(4), Judge Forrest concluded “that the [witness] fall[s] outside the bankruptcy court’s subpoena power because it defines witnesses who are ‘more than 100 miles from the place of . . . trial’ as ‘unavailable.’” She found

no indication in this rule that the geographical limitation can be recalibrated under Rule 43(a) to the location of a remote witness rather than the location of trial, nor is there any indication that courts can avoid the consequences of a witness’s unavailability by ordering remote testimony.

Describing how the two rules work together, Judge Forrest held:

Rule 43 does not give courts broader *power* to compel remote testimony; it gives courts *discretion* to allow a witness otherwise within the scope of its authority to appear remotely if the requirements of Rule 43(a) are satisfied. [Emphasis in original.]

Next, Judge Forrest said that interpreting the “place of compliance” to be the location of the witness “is contrary to Rule 45(c)’s plain language that trial subpoenas command a witness to ‘attend *a trial*.’” [Emphasis in original.] Indeed, if the place of compliance were the location of the witness,

there would be no reason to consider a long-distance witness “unavailable” or for the rules to provide an alternative means for presenting evidence from long-distance witnesses that are not subject to the court’s subpoena power.

Finding that the witness satisfied the third *Bauman* factor, Judge Forrest held “that the bankruptcy court ‘misinterpreted the law’ in its construction of Rule 45(c) as applied to witnesses allowed to testify remotely under Rule 43(a).

Proceeding to find that the witness had also satisfied the other *Bauman* factors, Judge Forrest issued the writ of mandamus, ordering the bankruptcy court to quash the trial subpoena.

[The opinion is](#) *Kirkland v. U.S. Bankruptcy Court (In re Kirkland)*, 22-70092 (9th Cir. July 27, 2023).



Plans & Confirmation



The U.S. Attorney argued in district court that the Voyager plan would bar the government from enforcing federal regulations and criminal laws.

Rebuffed in Bankruptcy Court, the Government Wins a Stay of Voyager's Confirmation

Granting a motion by the U.S. Attorney and the U.S. Trustee, District Judge Jennifer H. Rearden of New York granted a stay pending the government's appeal of the March 8 order confirming the chapter 11 plan for Voyager Digital Holdings Inc.

Voyager filed a chapter 11 petition in Manhattan in July, originally intending to sell the business and assets to FTX. After FTX itself ended up in bankruptcy with some of its executives indicted, Voyager tapped Binance.US to buy the assets, including cryptocurrencies held by the debtor and its customers. Binance is the world's largest cryptocurrency exchange.

Following confirmation, the plan called for so-called rebalancing transactions together with a distribution of cryptocurrencies to creditors.

The debtor's chapter 11 plan contained releases and exculpations running in favor of parties who participated in the chapter 11 case, including Binance.US. When state and federal governmental units filed objections, the debtor amended the plan to carve governments out from the releases and exculpations.

On March 2, when the confirmation hearing began, Judge Rearden said in her March 31 opinion that the debtor amended the plan in a manner that "would effectively undo the Government carve-out they had previously proposed." To no avail, the government objected, and the bankruptcy judge confirmed the plan on March 8.

The release and exculpation provisions are lengthy, complex, convoluted and (in this writer's judgment) susceptible to varying interpretations.

In the words of the U.S. Attorney, the exculpation clauses "would relieve various parties of liability based on the negotiation, execution, and implementation of any transactions or actions approved by the bankruptcy court, except for certain causes of action premised on actual fraud, willful misconduct or gross negligence."

Significantly, the U.S. Attorney interpreted the exculpations to mean that "no exculpated parties may be liable for distributing cryptocurrencies in the manner provided in the plan." The



government interpreted the plan to mean that “the Government’s only remedy would be to seek prospective relief to enjoin any ongoing transactions that it comes to believe are illegal.”

The government took the position that a plan cannot allow the enforcement of federal statutes only if the “causes of action sound in actual fraud, willful misconduct, or gross negligence.” According to the government, the exculpation “also applies to transactions that will take place after the plan’s effective date. For such future transactions, it is impossible to know in advance what the parties will actually do, and whether they will engage in any misconduct.”

To enforce laws and regulations, the U.S. Attorney argued that the plan would require the government first to obtain an injunction. Absent an injunction before the fact, the exculpations would cut off government enforcement. Because the plan would become effective shortly after any stay expires, the government would have little time to obtain an injunction.

In short, the U.S. Attorney believes that the plan would “improperly” bar “the Government from enforcing its laws and regulations in the ordinary course against the Debtors and third parties in connection with the Restructuring Transactions.”

Putting the provisions together, the U.S. Attorney said that the “exculpation would bar the Government from exercising its police and regulatory authority, including its power to prosecute crimes, unless the laws it seeks to enforce sound in actual fraud, willful misconduct, or gross negligence.”

Moreover, the government saw the plan as absolving “Exculpated Parties not just for conduct that took place during the bankruptcy but also for the ‘implementation of any transactions’ contemplated by the plan that will largely happen after the plan becomes effective.”

The Motion for a Stay

The government filed an appeal from the confirmation order and sought a stay pending appeal. When the bankruptcy court denied the government’s motion for a stay pending appeal, the government applied to Judge Rearden for a stay on March 17.

Having taken briefs and heard argument, Judge Rearden granted a stay pending appeal on March 27 and filed an opinion and order on March 31 stating reasons for the stay. Given the urgency in the matter, Judge Rearden is expediting the appeal from the confirmation order. The last brief is due on April 18.

The Reasons for a Stay Pending Appeal

Addressing the merits, Judge Rearden cited the usual four factors governing the exercise of discretion in granting a motion for a stay pending appeal: (1) a strong showing of a likelihood of



success on appeal; (2) irreparable injury; (3) whether a stay will injure other parties; and (4) where the public interest lies.

Judge Rearden said that the government had demonstrated “substantial questions” about the power of the bankruptcy court on one hand versus police and regulatory powers on the other.

In that respect, she said that bankruptcy courts have “limited, if any, jurisdiction over criminal cases.” For example, criminal prosecutions and enforcement actions are not subject to the automatic stay, she said, citing Section 362(b)(1), (4).

Judge Rearden said that the debtor and the creditors’ committee offered no “authority for the proposition that a bankruptcy court can release criminal liability.” She added that “preventing Government enforcement actions is at odds with the general principle that ‘confirmation of a plan does not insulate debtors from prosecution for criminal activity, even if that activity is part of the plan itself,’” citing the Ninth Circuit.

On the other hand, Judge Rearden said it was “likely” that quasi-judicial immunity might apply to some parties, but the exculpations appear “to go further than the quasi-judicial immunity doctrine allows.” For example, judicial immunity does not preclude injunctive relief.

More to the point, Judge Rearden said that “neither the Debtors nor the Committee has offered any authority rebutting the proposition that immunity must be raised as an affirmative defense, rather than granted preemptively before any action has even taken place.”

The government had shown a substantial case on the merits that weighed in favor of a stay, Judge Rearden said.

Likewise, Judge Rearden said that the injury and public interest factors also favored a stay. “There is,” she said, “a fundamentally strong public interest in the Executive Branch’s enforcement of the democratically enacted laws of the United States.”

“Furthermore,” Judge Rearden said that a stay pending appeal would preserve the government’s “and the public’s” right to meaningful appellate review because equitable mootness could moot the appeal.

While each side had shown “unquantifiable and irreparable injury,” Judge Rearden concluded that “the balance of hardship lies with the government.” She granted the stay pending appeal, finding a substantial case on the merits and irreparable harm absent a stay.

Update: The debtor and the creditors’ committee have filed emergency appeals, asking the Second Circuit to vacate Judge Rearden’s stay pending appeal.



The opinion is [U.S. v. Voyager Digital Holdings Inc. \(In re Voyager Digital Holdings Inc.\)](#),
23-02171 (S.D.N.Y. March 31, 2023).



The Second Circuit adapts Rash to value the lender's collateral in chapter 11 where there was a going-concern sale.

Second Circuit Says Orderly Liquidation Value Is Proper for a Retailer in Chapter 11

When an orderly going-out-of-business sale is a “genuine possibility” for a retailer in chapter 11, the Second Circuit says that secured lenders’ collateral can be valued as of the filing date at the orderly liquidation value, less expenses, not at the higher book value or replacement cost.

The Second Circuit’s October 14 opinion is an extrapolation (or perhaps departure) from *Rash*, where the Supreme Court commanded in a chapter 13 case that the value of collateral retained by the debtor must be based on the “actual use” of the collateral. *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997).

In the case on appeal, the “actual use” of the collateral actually turned out to be a going-concern asset sale that presumably realized more than a going-out-of-business sale. The Second Circuit nonetheless upheld a valuation for less than going-concern value.

The Second Circuit worked from the proposition that the valuation must be made as of the filing date. At that time, the appeals court believed it was reasonable to expect a going-out-of-business sale rather than a going-concern sale.

The opinion is a testament to the respect that the Second Circuit has for the findings of fact by a well-regarded bankruptcy judge, Robert D. Drain of White Plains, N.Y.

The Sears Going-Concern Sale

The opinion by Circuit Judge Richard J. Sullivan was 13 months in the making. It involves the chapter 11 reorganization of Sears, the retailer that operated almost 700 stores when the filing took place in 2018.

The debtor had first- and second-lien lenders with \$2.7 billion in liens on inventory. Under Section 363, Bankruptcy Judge Drain gave them “adequate protection” for the use of their collateral in the form of replacement liens and a super-priority under Section 507(b) over all other creditors’ claims if there were a decline in value of the collateral after filing.

Unable to reorganize on its own, the debtor sold the business as a going concern to its largest secured creditor for about \$5.2 billion. The buyer paid for the assets largely with non-cash



consideration, including a \$433.5 million credit bid. Under an intercreditor agreement, second-lien lenders were obliged to participate in the credit bid.

As Judge Sullivan said, the credit bid “for practical purposes forgave debt that the Debtors owed to [the first- and second-lien lenders] in exchange for a dollar-for-dollar reduction in the purchase price.”

The second-lien lenders, however, contended that the \$433.5 million credit bid fell “far short” of the value of the collateral on the petition date. Rather, they argued there had been a diminution in the value of their collateral, entitling them to a super-priority claim.

To resolve the controversy, Bankruptcy Judge Drain was called on to fix the filing-date value of the collateral and then subtract the obligations to the first-lien lenders as of the filing date. Judge Sullivan said that the second-lien holders would “have a viable section 507(b) super-priority claim only if this figure exceeds the \$433.5 million credit bid [that the buyer] already recouped in the transaction.”

Judge Sullivan described how the bankruptcy court had heard from expert witnesses whose collateral values “varied widely.” He characterized Judge Drain as having considered the full retail price as the highest valuation and a going-out-of-business liquidation for the lowest value.

Instead, Judge Drain settled on the so-called NOLV, or net orderly liquidation value, which Judge Sullivan defined to mean “an orderly company-wide going out of business sale that would sell the Debtors’ assets at more than their liquidation value, but less than their full retail price.”

Judge Sullivan said that Judge Drain adopted the “NOLV because, on the Petition Date, a complete liquidation of the Debtors’ assets was a genuine possibility.” After deducting overhead and legal fees, Judge Drain found as a fact that the filing-date value of the inventory was 87.4% of book value, or about \$2.15 billion.

From the \$2.15 billion, Judge Drain subtracted first-lien claims totaling almost \$2 billion, yielding a net of \$187 million for second-lien creditors. Since the second-lien holders “had already realized more than this from the \$433.5 million credit bid, the bankruptcy court held that they were not entitled to any further recovery in the form of section 507(b) super-priority claims,” Judge Sullivan said.

The junior lenders appealed, but the district court affirmed, and so did Circuit Judge Sullivan.

The Law on Chapter 11 Valuations, According to the Second Circuit

The junior lenders argued on appeal that the bankruptcy court should have valued the inventory at book value or replacement value. Judge Sullivan measured the argument against *Rash* and



Section 506(a)(1). The section says that the value of collateral “shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property”

Rash was a chapter 13 case involving a truck. The Supreme Court held that the bankruptcy court was required to use “replacement value” because the debtor retained and continued to use the truck. Judge Sullivan characterized *Rash* as respecting “the debtor’s ‘actual use’ of the collateral, ‘rather than’ taking cues from ‘a foreclosure sale that will not take place.’” *Rash, supra*, at 963.

The Sears valuation intimately involved Section 506, which requires consideration of the “disposition or use” of collateral. Judge Sullivan said that *Rash* “had no need to address” Section 506. He also said that *Rash* did not involve the valuation of retail inventory.

Still, Judge Sullivan said that *Rash* was “instructive” because the debtor had elected to use the truck to generate income. Thus, he said, “actual use” was the proper guide for valuation.

Judge Sullivan inferred that “*Rash* contemplated that one *particular* use or disposition must be proposed, and that this proposal must guide the valuation exercise.” [Emphasis in original.] Deferring to the bankruptcy court’s findings, he said that Judge Drain “reasonably decided” on using NOLV because it assessed “what the Debtors would likely be able to recoup from the collateral.” He characterized NOLV as “somewhere between a forced liquidation and . . . full retail price.”

“Far from being erroneous,” Judge Sullivan said that NOLV “was, by any measure, a sensible one.”

No to Retail Value

Because the debtor did not liquidate immediately, the junior lenders argued that the court should have used retail value, given that the stores continued operating after filing.

“But,” Judge Sullivan said, valuation “turned on the value of the collateral on the Petition Date, without inquiring into how the collateral was *ultimately* used.” [Emphasis in original.] In a footnote, he noted how the lenders proffered no authority for the idea that the court must make the filing-date valuation “in light of subsequent developments.”

Again deferring to the bankruptcy court’s findings, Judge Sullivan said that Judge Drain’s “decision to settle on an orderly liquidation value was therefore not an unreasonable conclusion.”

Judge Sullivan ended his review of inventory valuation by focusing on whether 87.4% of book value was “clear error.” He found “no error of fact or law.”



The last few pages of Judge Sullivan’s opinion dealt with two other types of collateral. One was inventory in transit on the filing date, to which Judge Drain gave no value. The other was almost \$400 million in letters of credit that were undrawn on the filing date and were the lenders’ collateral.

As to both, the lenders suffered from a failure of proof. Judge Sullivan said that Judge Drain “reasonably rejected” the only valuation proffered by the lenders for in-transit inventory. With regard to the letters of credit, he said that the lenders made “little effort to defend a valuation other than ‘zero.’”

Affirming the lower courts, Judge Sullivan ruled that “the bankruptcy court did not commit clear error by denying the second-lien holders’ section 507(b) claims.”

[The opinion is](#) *ESL Investments Inc. v. Sears Holding Corp. (In re Sears Holding Corp.)*, 20-3343 (2d Cir. Oct. 14, 2022).



There's no circuit split on post-petition interest, because the Second Circuit agreed with the Third, Fifth and Ninth Circuits.

Second Circuit: Unimpaired, Unsecured Creditors Don't Get Post-Petition Interest

Avoiding a circuit split, the Second Circuit joined the Third, Fifth and Ninth Circuits by holding on December 14 “that a claim is impaired under Section 1124(1) only when the plan of reorganization, rather than the [Bankruptcy] Code, alters the creditor’s legal, equitable, or contractual rights.”

Consequently, an unsecured creditor of an *insolvent* debtor is not entitled to post-petition interest even though the claim is unimpaired by the plan. In other words, an unsecured creditor remains unimpaired because Section 502(b)(2) disallows post-petition interest as being unmaturing on the petition date.

The Second Circuit did not reach the question of whether unsecured creditors of a *solvent* debtor are entitled to post-petition interest. That question is going to the Third Circuit on direct appeal.

The Plan

The debtor was a holding company for several Latin American airlines. All were in chapter 11. With an equity infusion of more than \$5.4 billion, the debtor proposed a plan where the unsecured claims of a Brazilian subsidiary would not be impaired.

More specifically, the plan said that the unsecured creditors would receive the full allowed amount of their claims or whatever treatment was necessary for them to be unimpaired. The debtors interpreted the plan to mean that it would pay \$300 million on the subsidiary’s unsecured claims, but not an additional \$150 million in post-petition interest.

The creditors objected to confirmation, contending that they would not be unimpaired under Section 1124(1) without post-petition interest. The creditors also argued that their debtor was solvent and that they should be paid post-petition interest under the so-called solvent-debtor exception to the general rule that interest for unsecured creditors ceases on filing.

The debtors contended that the relevant debtor was insolvent. A valuation battle ensued where the creditors posited evidence and argument to show solvency. The debtors countered with an analysis showing insolvency.



Bankruptcy Judge James L. Garrity, Jr. of New York sided with the debtors and found insolvency. He also overruled the creditors' objection and confirmed the plan. The district court affirmed. *LATAM Airlines Grp. S.A.*, 20-11254, 2022 WL 2206829 (Bankr. S.D.N.Y. June 18, 2022), *as amended*, 2022 WL 2541298 (Bankr. S.D.N.Y. July 7, 2022); *aff'd In re LATAM Airlines Grp. S.A.*, 643 B.R. 741 (S.D.N.Y. 2022).

The creditors appealed to the Second Circuit.

No Circuit Split

Circuit Judge Pierre N. Leval began his analysis of the merits by stating the general rule that interest ceases to accrue on a bankruptcy filing. Before enactment of the Bankruptcy Code in 1978, the Second Circuit had adopted the solvent-debtor exception allowing post-petition interest to creditors of a solvent debtor before a surplus is returned to the debtor.

Judge Leval said that “the rule against post-petition interest is codified at 11 U.S.C. § 502(b)(2).” He described the subsection as disallowing “unmatured interest.”

Unlike the Fifth and Ninth Circuits, which recently ruled that the solvent-debtor exception did not survive adoption of Section 502(b)(2), Judge Leval said that his court had “not yet addressed” the question. *See Ad Hoc Committee of Holder of Trade Claims v. Pacific Gas & Electric Co. (In re Pacific Gas & Electric Co.)*, 46 F.4th (9th Cir. Aug. 29, 2022); and *Ultra Petroleum Corp. v. Ad Hoc Committee of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, 51 F.4th (5th Cir. Oct. 14, 2022). To read ABI's reports, click [here](#) and [here](#).

[Note: After ruling that the exception did survive the Code, a bankruptcy judge in Delaware recently certified the same question for direct appeal to the Third Circuit. *See Wells Fargo Bank NA v. Hertz Corp. (In re Hertz Corp.)*, 21-50995 (Bankr. D. Del. Nov. 21, 2021). To read ABI's report, [click here](#).]

For the notion that they were entitled to post-petition interest, the creditors relied primarily on Section 1124(1) and its description of the requisites of unimpairment. The section says a claim is unimpaired “under a plan” if it “leaves unaltered the [creditor's] legal, equitable, and contractual rights” and “does not otherwise alter the legal, equitable, or contractual rights to which such claim or interest entitles the holder of such claim or interest.”

Although other circuits have held that the section “sweeps broadly,” Judge Leval said:

[T]he Third, Fifth, and Ninth Circuits have noted a significant caveat: Because Section 1124(1) refers to impairment imposed by a “plan,” these circuits have held it inapplicable to modifications which occur by operation of the Code.



The creditors implored Judge Leval not to follow the three circuits but instead to adopt the rationale of two bankruptcy courts in the late 1990s that held that post-petition interest must be allowed to render a claim unimpaired. Judge Leval declined the invitation in favor of following the three circuits.

Finding the three circuits' opinions to be "persuasive," Judge Leval held "that a claim is impaired under Section 1124(1) only when the plan of reorganization, rather than the Code, alters the creditor's legal, equitable, or contractual rights." In other words, creditors' "claims are not impaired simply because they did not receive post-petition interest."

Creditors' Arguments Rejected

The creditors posited arguments based on statutory language, the same arguments that did not persuade the three circuits.

The creditors pointed to the statute's use of "claims" rather than "allowed claims." Like the three circuits, Judge Leval said the section does not state that "claims" are unaltered but that "instead, it protects 'the legal, equitable, and contractual *rights* to which such claim or interest entitles the holder of such claim or interest.' 11 U.S.C. § 1124(1) (emphasis added)."

Judge Leval also rejected the creditors' argument based on statutory history and, in particular, the elimination of Section 1124(3). He explained that it was deleted in response to *In re New Valley Corp.*, which read the subsection to mean that solvency alone wasn't enough to require post-petition interest for unsecured creditors.

Judge Leval cited the legislative history for the subsection's repeal to "ensure that solvent debtors pay post-petition interest on their claims."

Solvent or Insolvent?

On a different line of attack, the creditors argued that the debtor was solvent, not insolvent as the bankruptcy court had found. On appeal in the circuit, the creditors did not advance arguments about the facts, but rather about legal issues underpinning the proper method of valuation.

The creditors argued that the absolute priority rule invokes the solvent-debtor exception. In particular, they relied on the Supreme Court's *Consolidated Rock* opinion from 1941 and its statements about absolute priority. In response, Judge Leval cited the Second Circuit for having said in 1998 that the Code did not codify any pre-Code version of the absolute priority rule.

Looking at absolute priority as it reads today in Section 1129(b)(2)(B), one of the alternatives says that cramdown requires creditors to receive "the allowed amount of such claim."



Because the creditors are receiving the allowed amount of their claims, Judge Leval said that they “cannot insist on compliance with the absolute priority rule. Because such a plan satisfies Section 1129(b)(2)(B)(i), there is no need for it to satisfy Section 1129(b)(2)(B)(ii).”

Judge Leval concluded by saying:

We therefore do not believe that the absolute priority rule provides the relevant test for solvency. We accordingly reject the argument that the Bankruptcy Court was required, as a matter of law, to apply the solvent debtor exception under these circumstances.

Judge Leval ruled that the bankruptcy court had correctly found the debtor to be insolvent and had correctly ruled that the creditors were not impaired because the plan did not impair the claims. He affirmed.

[The opinion is](#) *LTA Claimholders Group v. LATAM Airlines Group S.A. (In re LATAM Airlines Group S.A.)*, 22-1940 (2d Cir. Dec. 14, 2022).



The Fourth Circuit wrote a scholarly (and dense) opinion differentiating among bankruptcy standing, bankruptcy appellate standing and constitutional standing.

Fourth Circuit Says an Insurer Has No Right to Negotiate an 'Asbestos' Plan

In an appeal dealing with an “insurance neutral” chapter 11 plan resolving asbestos claims, the Fourth Circuit explored the differences among standing in bankruptcy court under Section 1109(b), standing to appeal in bankruptcy cases and constitutional or Article III standing.

The February 14 opinion is perhaps most significant because it holds that an insurer has no right to participate in negotiations dealing with the insurance policy, as long as the plan ends up being “insurance neutral.”

The opinion by Circuit Judge G. Steven Agee teaches us that an insurance company found by the bankruptcy court to have no standing does have standing to appeal the denial of standing to object to confirmation of the chapter 11 plan. On the other hand, if the appeals court confirms that the plan is “insurance neutral,” then the insurance company has no standing in the bankruptcy court or on appeal to object to the merits of the plan pertaining to any other aspects of the plan.

The ‘Asbestos’ Case

Faced with 14,000 pending lawsuits, the corporate debtor proposed a chapter 11 plan under Section 524(g) to create a trust dealing with present and future asbestos claims. All asbestos claims were to be channeled to the trust.

The principal asset for the trust was the debtor’s primary insurance policy, with a coverage limit of \$500,000 per claim. The insurer was obliged by the policy to defend and indemnify the debtor, even if the claim were false or fraudulent. The policy had no maximum aggregate limit, and it was non-eroding, meaning that defense costs were not counted against the policy limit for each claim.

The plan divided asbestos claims into two classes: (1) those covered by the policy; and (2) those not covered by the policy. Uninsured claims were to be paid entirely by the trust.

Claims covered by insurance were to be litigated in the tort system, nominally against the debtor but subject to the coverage limit for each claim. The trust would pay the \$5,000 deductible for each claim.



The claims covered by insurance remained subject to the insurer's prepetition coverage defenses.

The uninsured claims were subject to antifraud provisions under the plan to protect the trust by requiring the claimants to provide disclosures designed to avoid fraud and duplicate claims. The plan had no antifraud provisions for insured claims.

Unsecured creditors were to be paid in full.

The asbestos claimants, the only class impaired by the plan, voted unanimously in favor of the plan. The only confirmation objection came from the insurer.

The insurer contended that the plan was not proposed in good faith and that the plan was not insurance neutral. The bankruptcy court wrote an opinion recommending that the district court approve the plan, finding that it was insurance neutral and filed in good faith. Because the plan was insurance neutral, the bankruptcy court concluded that the insurer was not a party in interest under Section 1109(b) and thus lacked standing to challenge the plan.

The district court confirmed the plan, adopting the bankruptcy court's findings *in toto* after *de novo* review.

The insurer appealed to the circuit.

Bankruptcy Standing

The debtor contended that the insurer had no standing to appeal because the plan was insurance neutral.

In the Fourth Circuit, the concept of bankruptcy appellate standing requires that the appellant be a "person aggrieved" who is directly and adversely affected in a pecuniary sense.

The former Bankruptcy Act had a provision specifically imposing the "person aggrieved" test for appellate standing. The textual limitation was omitted alongside adoption of the Bankruptcy Code in 1978, but Judge Agee noted how circuit courts continued imposing the "person aggrieved" test.

Judge Agee described the differences between standing in bankruptcy court and standing to appeal.



For standing in bankruptcy court, distinguished from standing to appeal, the insurer's standing was governed by Section 1109(b), which confers on "[a] party in interest, including . . . a creditor . . . ," the right to "appear and be heard on any issue" in the chapter 11 case.

Judge Agee held that the insurer "indisputably [had] standing to appeal the district court's conclusion that it lacked § 1109(b) standing, either as an insurer or as a creditor, to challenge the Plan in the first instance." He pointed to the Third Circuit for having held that standing to appeal the substance of the bankruptcy court's decision is distinct from the right to appeal "bankruptcy standing" under Section 1109(b).

Were a creditor unable to appeal denial of bankruptcy standing under Section 1109(b), Judge Agee again cited the Third Circuit for the proposition that an erroneous finding of a lack of bankruptcy standing would preclude the creditor from appealing the erroneous finding.

In sum, Judge Agee said that the insurer had standing to appeal the district's decision that it did not have bankruptcy standing under Section 1190(b). In a footnote, he also said that the insurer had Article III, or constitutional, standing to challenge the finding of insurance neutrality.

Insurance Neutrality

If the plan was truly insurance neutral, then the insurer would have no bankruptcy standing. Judge Agee reviewed the neutrality findings *de novo*.

Following the Third Circuit, Judge Agee said that a plan is insurance neutral if it does not increase the insurer's prepetition obligations or impair the insurer's prepetition rights under the policy. He found the plan to be neutral, in part because it preserved the insurer's coverage defenses.

The insurer had other arguments. Primarily, the insurer contended that the plan was not insurance neutral because the debtor precluded the insurer from negotiating the plan.

Judge Agee found "nothing in the policy provision [that] suggests that the Debtors' assistance-and-cooperation obligations extend to bankruptcy-plan negotiations." More particularly, he said that the debtor's assistance obligations under the policy involve "traditional litigation activities, as opposed to activities typically undertaken in a bankruptcy proceeding."

The insurer also contended that the plan was not neutral because insured claims were not subjected to the antifraud provisions that applied to uninsured claims. Judge Agee rejected the argument, because "those alleged rights never existed under the policies."

Having found that the plan indeed was insurance neutral, Judge Agee held that the insurer, but only in its capacity as an insurer, did not have bankruptcy standing as a party in interest under Section 1109(b).



Bankruptcy Appellate Standing

The insurer argued that it also had standing on appeal to challenge other provisions of the plan, such as good faith, because it also was a creditor on account of unpaid deductibles. In that respect, Judge Agee said that the insurer, in its capacity as a creditor, was subject to the strictures of Article III standing, also known as constitutional standing. That is to say, was there a case or controversy?

As a creditor, the insurer was unimpaired and had no objections to its treatment as a creditor. Thus, Judge Agee said, the insurer alleged no injury in fact as a creditor. Consequently, the insurer had no Article III standing “to object to aspects of a reorganization plan that in no way relate to its status as a creditor but instead implicate only the rights of third parties (who actually support the Plan).” [Emphasis in original.]

Judge Agee affirmed the district court’s judgment because (1) insurance neutrality left the insurer bereft of bankruptcy standing under Section 1109(b), and (2) the insurer had no Article III standing as a creditor to object to other aspects of the plan.

[The opinion is](#) *Truck Insurance Exchange v. Kaiser Gypsum Co. (In re Kaiser Gypsum Co.)*, 21-1858 (4th Cir. Feb. 14, 2023).



Creating a circuit split, the Fifth Circuit holds that the solvent-debtor exception to the allowance of post-petition interest survived adoption of the Bankruptcy Code.

Possibly *Dicta*, the Fifth Circuit Disallows Make-Wholes

Institutional lenders and bondholders won big and lost big in an October 14 opinion from the Fifth Circuit. If you're an unsecured lender with a "make-whole" and "default interest" owing by a *solvent* debtor, you won. If an *insolvent* debtor owes you a "make-whole," you lost.

Unanimously, the Fifth Circuit panel decided that a so-called make-whole is "the economic equivalent of unmatured interest" and is therefore disallowed by Section 502(b)(2). The opinion may or may not have created a *cert*-worthy circuit split.

In a 2/1 ruling, the majority upheld the bankruptcy court's decision that the so-called solvent-debtor exception to the disallowance of post-petition interest was not abrogated by the adoption of the Bankruptcy Code in 1978. The decision in this regard does seem to give rise to a circuit split.

The lenders in the Fifth Circuit lost on make-wholes as a stand-alone issue, but they walked away with victory because the majority decided that the solvent-debtor exception survives. Consequently, the majority awarded the lenders both the make-whole plus default interest at the higher contract rate. The majority's holding on the solvent-debtor exception created a split of circuits.

The dissent and the circuit splits invite the debtor to file a petition for rehearing *en banc* or a petition for *certiorari* to the Supreme Court, or both.

Ultra Resources, a 'Massively' Solvent Debtor

Ultra Resources, an oil and gas producer, was forced into chapter 11 in 2016 when the price of petroleum imploded. Insolvent on filing, both the bankruptcy court and the Fifth Circuit said that the debtor became "massively solvent" when oil prices rose. The solvent debtors proposed a plan where creditors were unimpaired and thus not entitled to vote on the plan.

The bondholders' loan agreement included a make-whole premium, which compensates a lender for being forced to reinvest at a lower interest rate if the loan is paid before maturity. The



plan did not pay the make-whole, contending that it was unmatured interest disallowed under Section 502(b)(2).

The bondholders' and the revolving credit lenders' loan agreements both called for interest after default of about 2 percentage points higher than the contract rate. The plan, however, only proposed paying post-petition interest at the federal judgment rate, not at the higher default rate called for by the loan agreements.

Although not entitled to vote on the plan, the noteholders and revolving-credit lenders objected to the plan. To confirm the plan without resolving the objection, the bankruptcy court set aside \$400 million to compensate the bondholders and the revolving-credit lenders if the court were later to decide that their claims for the make-whole and the default rate must be paid for the claims to be unimpaired.

Later, the bankruptcy court ruled that the claims must be paid in full under state law for the lenders to be unimpaired. The bankruptcy court did not decide whether make-wholes are prohibited under Section 502(b)(2) or whether the solvent-debtor exception persisted after the adoption of the Code.

The lenders appealed, and the bankruptcy court certified a direct appeal to the Fifth Circuit.

For now truncating the procedural history, suffice it to say that the Fifth Circuit reversed, holding in November 2019 that disallowing the make-whole and default interest under provisions of the Bankruptcy Code by itself did not render the claims impaired. *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 943 F.3d 758 (5th Cir. Nov. 26, 2019). To read ABI's report, [click here](#).

The circuit court said that the bankruptcy court was "best able" to rule in the first instance on the allowance of make-wholes and default interest. *Id.* at 765. Nonetheless, the appeals court went on to say, "Our review of the record reveals no reason why the solvent-debtor exception could not apply." *Id.*

Back in bankruptcy court on remand, Bankruptcy Judge Marvin Isgur of Houston ruled that make-wholes were *not* the equivalent of unmatured interest and should be allowed for the creditors to be unimpaired. Likewise, he concluded that the solvent-debtor exception was not abrogated by the adoption of the Bankruptcy Code. He therefore allowed both the make-whole and the default rates of interest. *In re Ultra Petroleum Corp.*, 624 B.R. 178 (Bankr. S.D. Tex. Oct. 26, 2020). To read ABI's report, [click here](#).

For a second time, the Fifth Circuit agreed to hear a direct appeal.

Make-Wholes Aren't Allowed



On the allowance of make-wholes, the lenders lost the battle as a general principle but won the war because the majority, as we shall discuss later, decided they were entitled to makes-wholes and default interest given to a solvent debtor.

Writing the opinion for the panel on make-wholes, Circuit Judge Jennifer Walker Elrod first analyzed whether make-wholes are a disguised form of unmatured interest to be disallowed as a matter of law under Section 502(b)(2). That section disallows a claim “to the extent that . . . such claim is for unmatured interest.”

In substance, Judge Elrod saw her panel as being bound by *In re Pengo Indus., Inc.*, 962 F.2d 543, 546 (5th Cir. 1992), where the Fifth Circuit held that original-issue discount is disallowed as unmatured interest as a matter of “economic fact.” Interpreting *Pengo*, she said, “What matters in this context is the underlying ‘economic reality’ of the thing — not dictionary definitions or formalistic labels.”

In other words, Judge Elrod said, a claim is disallowed if it “is really just the functional equivalent of unmatured interest.”

Applying *Pengo*’s principles, Judge Elrod said that a make-whole “compensates Creditors for the *future* use of their money. . . . This is simply another way of saying that the interest is *unmatured*. And unmatured interest is still interest.” [Emphasis in original.]

Judge Elrod rejected the notion that make-wholes are liquidated damages, which some lower courts have allowed. She held that a make-whole “is indeed a claim for unmatured interest or its economic equivalent [and is] disallowed under 11 U.S.C. § 502(b)(2).”

The Solvent-Debtor Exception

Although defeated on unmatured interest, the lenders had another route to victory: the solvent-debtor exception to the disallowance of interest in bankruptcy cases. Here, they won.

Ordinarily, Judge Elrod said, a make-whole would be disallowed. “But this is not an ordinary case,” she said, because the debtor was solvent.

Judge Elrod traced the 300-year history of the solvent-debtor exception. Generally, English common law disallowed interest on creditors’ claims after bankruptcy or the equivalent. The solvent-debtor exception allowed claims for interest when the debtor was solvent.

Judge Elrod cited the Supreme Court for saying that the exception was imported into the U.S. from England and was embraced by the Bankruptcy Act of 1898.



The debtor argued that the exception had been abrogated by the adoption of the Bankruptcy Code in 1978 and the absolute language in Section 502(b)(2). Judge Elrod cited the First and Sixth Circuits for holding that interest is disallowed under the Code even if the debtor is solvent.

Addressing the seemingly absolute language in Section 502(b)(2), Judge Elrod said, “[O]ne would expect [Congress] to have *expressly* abrogated the judicial exception if it intended to do so.” [Emphasis in original.] She supported her notion of statutory interpretation by alluding to Supreme Court authority, which she interpreted to mean that “[w]e must defer to prior bankruptcy practice unless expressly abrogated.”

Because the alleged abrogation of the solvent-debtor exception was not “absolutely clear,” Judge Elrod held that the exception “is alive and well.” For that reason, she said that the debtor must pay the make-whole, “even though . . . it is indeed otherwise disallowed unmatured interest.”

The Make-Whole Is Enforceable

So far, Judge Elrod had been working on the assumption that the make-whole was enforceable under New York law governing the loan agreements. The debtor contended that it was an unenforceable penalty.

To be a penalty under New York law, the make-whole must be grossly disproportionate to the probable loss. Because it wasn’t, Judge Elrod held that the make-whole was enforceable under New York law. Therefore, she said, “§ 502(b)(1) does not stand in the way of the solvent-debtor exception.”

Post-Petition Interest

The debtor conceded that the creditors were entitled to some post-petition interest because the estate was solvent. But the debtor also argued that the lenders were only entitled to the lower federal judgment rate in 28 U.S.C. § 1961(a), not the higher default rates in the loan agreements.

To find the answer, Judge Elrod studied the concept of impairment and the requirements of cramdown.

Section 726(a)(5) was seemingly relevant because cramdown requires proving that the creditors were being treated no worse than they would have been in a chapter 7 liquidation. As fifth priority when the debtor is solvent, the section requires “payment of interest at the legal rate from the date of the filing of the petition.”

At that juncture, Judge Elrod was confronted by *In re Cardelucci*, 285 F.3d 1231 (9th Cir. 2002), where the Ninth Circuit held that Section 726(a)(5) mandates the federal judgment rate.



However, she was able to avoid deciding, like *Cardelucci*, whether the reference to “the legal rate” in Section 726(a)(5) means the federal judgment rate in 28 U.S.C. § 1961(a).

Instead, Judge Elrod pointed out that Section 1129(a)(7)(ii) does not require paying the “legal rate” in a hypothetical chapter 7 case. Rather, it says that the creditor must receive an amount “that is not less than the amount that such holder would so receive” in chapter 7. In other words, she said that Section 726(a)(5) only sets a “floor,” not a “ceiling.”

Although Judge Elrod disagreed with the bankruptcy court regarding the allowance of a make-whole, the other considerations in her opinion led her to affirm the judgment of the bankruptcy court by giving the lenders “what they bargained for with this solvent debtor.”

The Dissent

Circuit Judge Andrew S. Oldham dissented in part. He agreed with the majority that “the Make-Whole Amount is unmatured interest in disguise.”

He parted company with the majority because he did not believe that the solvent-debtor exception survived adoption of the Bankruptcy Code. He read Section 502(b)(2) to mean that “all claims for unmatured interest are disallowed.”

Judge Oldman dissected the predecessors to the Bankruptcy Code and found that they prohibited “some” unmatured interest but did “not contain a blanket bar on all unmatured interest — unlike § 502(b)(2).” Specifically, he believes that unmatured interest was disallowed by a combination of Sections 63(a)(1) and 65(e) of the former Bankruptcy Act.

In contrast, Judge Oldham said that the Code “goes for the jugular by flatly disallowing ‘claim[s] for unmatured interest.’ 11 U.S.C. § 502(b)(2).”

Judge Oldham would have disallowed the make-whole and limited the lenders’ recovery to the federal judgment rate. He “respectfully” dissented.

Observations

The Fifth Circuit’s opinion also seems to raise a circuit split on the disallowance of make-wholes.

The Third Circuit allowed a make-whole in *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016), but the Second Circuit seemingly disallowed make-wholes in *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. 2017), *cert. den. sub nom BOKF*



N.A. v. Momentive Performance Materials Inc., 138 S. Ct. 2653 (2018). For some of ABI's coverage of *Energy Future* and *MPM*, click [here](#) and [here](#).

Bankruptcy Judge Isgur and some other courts believe that *MPM's* disallowance of make-wholes was *dicta*. If the Second Circuit's ruling was *dicta*, then there wasn't a concrete circuit split until the Fifth Circuit came along.

But think for a minute. Was the Fifth Circuit's decision *dicta* with regard to make-wholes?

The Fifth Circuit's disallowance of make-wholes was not necessary to the opinion, because the New Orleans-based court found other reasons for allowing a make-whole when the debtor is insolvent. Some therefore might say that the Fifth Circuit's opinion on make-wholes is *dicta*. The lack of a clear-cut circuit split on make-wholes doesn't make the case an attractive candidate for a grant of *certiorari* by the Supreme Court.

On the other hand, there is a circuit split on the Bankruptcy Code's abrogation (or not) of the solvent-debtor exception. To enhance the chance of a successful rehearing or a grant of *certiorari*, the debtor can also point to the dissent by Judge Oldham.

The Withdraw Opinion

We glossed over a curious procedural fact. The Fifth Circuit's prior opinion in November 2019 was not the first.

In January 2019 on the first direct appeal, Judge Oldham wrote at length about the allowance of make-wholes. *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 913 F.3d 533 (5th Cir. Jan. 17, 2019). To read ABI's reports on the original opinion, click [here](#).

When the debtor moved for panel rehearing, Judge Oldham withdrew the January opinion and issued a shorter opinion in November 2019, eliminating pages of *dicta* about make-wholes and limiting the ruling to a declaration that disallowance of portions of a claim by the operation of provisions of the Bankruptcy Code does not amount to "impairment" of the claim entitling the creditor to vote for or against confirmation of a chapter 11 plan.

Now, we have a second opinion by the Fifth Circuit on make-wholes, but it too may be *dicta*.

[The opinion is](#) *Ultra Petroleum Corp. v. Ad Hoc Committee of OpCo Unsecured Creditors (In re Ultra Petroleum Corp.)*, 21-200008 (5th Cir. Oct. 14, 2022).



Stays & Injunctions



The concurring opinion, which is really a dissent, urges the Supreme Court to grant certiorari and resolve the split of circuits on nondebtor releases.

Second Circuit Reverses, Reinstates Purdue's Nondebtor, Third-Party Releases

Reversing the district court, the Second Circuit reinstated the bankruptcy court's confirmation of the chapter 11 plan of Purdue Pharma LP and its inclusion of nonconsensual releases of creditors' direct claims against nondebtors.

In the majority's 74-page opinion, Circuit Judge Eunice C. Lee found statutory authority for nondebtor, third-party releases in Sections 105(a) and 1123(b)(6) of the Bankruptcy Code and in "this Circuit's caselaw stating that a bankruptcy court has authority to impose such releases."

Circuit Judge Richard C. Wesley wrote a 14-page concurrence that reads like a dissent and urges the Supreme Court to grant *certiorari* to resolve the split of circuits. Judge Wesley concurred in the judgment because he saw the issue as having been resolved in *In re Drexel Burnham Lambert Grp., Inc.*, 960 F.2d 285, 293 (2d Cir. 1992), Second Circuit authority that "has not been overruled either by the Supreme Court or by this Court sitting *en banc*."

The third judge on the panel was Circuit Judge Jon O. Newman. Having served 44 years on the appeals court, he is the most senior judge on the Second Circuit.

The Opioid Claims, the Chapter 11 Case, and Reversal in District Court

Judge Lee devoted 30 pages of her opinion to laying out the facts, the deluge of opioid claims against Purdue and the controlling Sackler family, the chapter 11 case, the confirmation of the plan by now-retired Bankruptcy Judge Robert D. Drain and the reversal of confirmation by District Judge Colleen McMahon of Manhattan.

Foretelling the result, Judge Lee pointed out early in her opinion that the Sacklers were contributing \$5.5 billion to \$6 billion in return for receiving releases.

To deal with tens of thousands of lawsuits, the company filed a chapter 11 petition in September 2019, but the Sacklers did not file, nor did any company officers or directors. One month after filing, the bankruptcy court imposed an injunction halting all lawsuits against debtors and nondebtors alike.



After bankruptcy, the company resolved a criminal complaint by entering into a plea agreement that called for the company to pay \$2 billion, which would come ahead of all creditor claims. However, the agreement would allow the company to pay most of the \$2 billion into a trust for the benefit of claimants.

Originally, Purdue's plan had a \$4.325 billion contribution to be made by the Sacklers over nine years. In return, the individuals were to receive releases that Judge Lee characterized as "extremely broad." With 95% in favor, she said that creditors "overwhelmingly" approved the plan.

During the course of the confirmation hearing, Bankruptcy Judge Drain required the debtors to narrow the scope of the third-party releases by providing that the debtor's conduct must be the legal cause or a relevant factor in the claims against released individuals.

As revised, Judge Drain confirmed the plan in September 2021 and delivered a lengthy, detailed opinion finding facts and stating the law as he saw it. He noted that while most circuits permit nondebtor releases, the Fifth, Ninth and Tenth Circuits don't.

Bankruptcy Judge Drain said the plan was the only reasonably conceivable means for resolving the case and satisfied the seven requirements demanded by *In re Iridium Operating LLC*, 478 F.3d 452, 464–66 (2d Cir. 2007). As authority for the nonconsensual releases, he found statutory power in Sections 105(a) and 1123(b)(6) and caselaw justification in *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005), and other Second Circuit authority.

The U.S. Trustee and several states appealed. District Judge McMahon set aside confirmation by reversing in December 2021. *In re Purdue Pharma, L.P.*, 635 14 B.R. 26 (S.D.N.Y. 2021). She found no statutory authority for the third-party releases. According to Judge Lee, the district judge "ejected the argument that the bankruptcy court possessed residual equitable authority to impose the Releases." To read ABI's report on the district court reversal, [click here](#).

The Appeal to the Circuit

The company, the official creditors' committee, the Sacklers and others appealed. The appeals court heard oral argument on April 29, 2022.

While the appeal was pending, nine states dropped their opposition to the plan when the Sacklers agreed to contribute an additional \$1.175 billion to \$1.675 billion, raising their total payments to as much as \$6 billion.

The U.S. Trustee was the remaining appellee, along with Canadian municipalities and indigenous tribes from Canada.



Addressing the merits, Judge Lee agreed with District Judge McMahon on one point: The bankruptcy court lacked constitutional power to enter a final judgment containing the third-party releases because they are the types of claims proscribed in *Stern v. Marshall*. In other words, the bankruptcy court could only issue proposed findings and conclusions for entry by the district court.

Judge Lee went on to say:

[W]e agree with the district court that the practical import of the *Stern* issue is nonexistent given that only conclusions of law are at issue here, requiring our *de novo* review under any standard.

[Note: This writer respectfully disagrees. It's not nothing. If the bankruptcy court may only enter proposed findings and conclusions in similar circumstances, a chapter 11 plan may not be confirmed and consummated until the equivalent of an appeal has been completed in district court.]

Question One

Judge Lee tackled the first of two pivotal questions: “[W]hether the bankruptcy court had the authority to approve the nonconsensual release of direct third-party claims against the Sacklers, a non-debtor.”

Judge Lee divided the releases into two categories: direct claims and derivative claims. Citing *Marshall v. Picard (In re Bernard L. Madoff Inv. Secs. LLC)*, 740 F.3d 81, 89 n.9 (2d Cir. 2014), she said it was “well settled” that the bankruptcy court may release derivative claims, which are those that arise from harm to the estate.

On the other hand, Judge Lee defined “direct claims [as] causes of action brought to redress a direct harm to a plaintiff caused by a non-debtor third party.” Citing *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir. 1988), she said that a release of those claims would not be a discharge prohibited by Section 524(e), “because the releases neither offer umbrella protection against liability nor extinguish all claims.”

Next, Judge Lee agreed “with both the bankruptcy court and the district court that the bankruptcy court had statutory jurisdiction to impose the Releases because it is conceivable, indeed likely, that the resolution of the released claims would directly impact [the estate].”

Statutory Authority

Judge Lee said that the bankruptcy court “correctly grounded its authority for approving the Releases in §§ 105(a) and 1123(b)(6).” Section 105(a) allows a bankruptcy court to issue “any order” that is “necessary or appropriate to carry out the provisions of” the Bankruptcy Code.



Section 1123(b)(6) permits a chapter 11 plan to “include any other appropriate provision not inconsistent with the applicable provisions of this title.”

Judge Lee rejected the debtor’s contention that Section 105(a) alone was up to the task. However, the combination of Section 105(a) with Section 1123(b)(6) made the magic elixir. She said that “§ 1123(b)(6) is limited only by what the Code expressly forbids, not what the Code explicitly allows.” She cited the Seventh Circuit for having “convincingly” held that the section includes the power to release third parties.

If there were any doubt before, Judge Lee said, “we now explicitly agree with [the Sixth and Seventh Circuits] and conclude that § 1123(b)(6), with § 105(a), permit bankruptcy courts’ imposition of third-party releases.”

Second Circuit Caselaw

Having found statutory power, Judge Lee said that “this Court’s precedents permit the imposition of nonconsensual third-party releases.” She said that *Manville* and *Metromedia* “further confirm that such releases are neither discharges nor allowable only in the context of asbestos cases.”

“More importantly,” Judge Lee said, “this Court’s opinion in *Metromedia* flatly rejects a restrictive interpretation of the Bankruptcy Code by stating that third-party releases can be valid outside of the asbestos context.” She added, though, that “*Metromedia* nevertheless rests upon the premise that such releases may be permitted so long as bankruptcy courts make sufficient factual findings and satisfy certain equitable considerations.”

Having found jurisdiction along with statutory and caselaw authority, Judge Lee analyzed the bankruptcy court’s findings of fact and concluded that they satisfied the seven-part test imposed by *Metromedia*. Among other factors, the releases were necessary; the nondebtors made substantial contributions, and the affected creditors voted “overwhelmingly” in favor of the plan. She pointed to Section 524(g)(2)(B)(ii)(IV)(bb) for the concept that a 75% vote is the minimum.

Before ending her opinion, Judge Lee rejected the U.S. Trustee’s argument that due process required that creditors be allowed to opt out.

Judge Lee reversed the district court, affirmed the bankruptcy court’s approval of the plan and remanded for proceedings consistent with the opinion.

The Concurrence by Judge Wesley



Judge Wesley concurred in the judgment, because he read *Drexel* to mean that bankruptcy courts “have the power to release direct or particularized claims asserted by third parties against nondebtors without the third parties’ consent.”

Because *Drexel* had not been overruled by the Supreme Court or the Second Circuit sitting *en banc*, Judge Wesley said he “reluctantly” concurred. He said that neither *Drexel* nor *Metromedia* “tracks that power back to any provision of the Bankruptcy Code.” Likewise, he saw nothing in Sections 105(a) or 1123(b)(6) about nondebtor releases. Indeed, he said that the Bankruptcy Code “is silent on the matter.”

To buttress his views, Judge Wesley noted that claims for fraud cannot be discharged in bankruptcy but that the third-party releases had no carveouts for fraud. In other words, the releases, he said, were “broader than that which Congress decided was wise to make available to a debtor in bankruptcy.”

Further, Judge Wesley said that creditors with direct claims receive nothing extra for those claims. Their recovery, he said, is identical to the recovery by a similar creditor with no direct claims against third parties.

“At bottom,” Judge Wesley said, “if Congress intended so extraordinary a grant of authority, it should say so,” like it did in 1994 when amending the Code to allow nondebtor releases in asbestos cases.

Given that nondebtor releases are “an extraordinarily powerful tool,” Judge Wesley said that the question “would benefit from nationwide resolution by the Supreme Court” of “a weighty issue that, for too long, has split the courts of appeals.”

The opinion is *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 22-110 (2d Cir. May 30, 2023).



The bankruptcy judge only gave nondebtor J&J companies a more limited stay in the second LTL chapter 11 case.

Ultimate Success of the J&J Subsidiary's Second 'Talc' Bankruptcy Is Up in the Air

From the latest opinion in Johnson & Johnson's second "Baby Powder" reorganization, it's unclear whether the bankruptcy judge will eventually dismiss the chapter 11 case or allow the debtor to proceed toward confirmation of a plan dealing with tens of thousands of talc claims.

J&J put its subsidiary LTL Management LLC back into chapter 11 two hours after the bankruptcy court dismissed the first case pursuant to the Third Circuit's mandate. Reversing the bankruptcy court on a direct appeal, the Court of Appeals had ruled in January that the first LTL chapter 11 case was not filed in good faith because there was no "financial distress." See *In re LTL Management LLC*, 58 F.4th 738, 64 F.4th 84 (3d Cir. Jan. 30, 2023). To read ABI's report on *LTL II*, [click here](#).

For the time being at least, Bankruptcy Judge Michael B. Kaplan of Trenton, N.J., is allowing the new case to remain in chapter 11. He is permitting talc plaintiffs to conduct discovery and motion practice, but he won't permit trials. However, he is keeping a lid on the multidistrict litigation.

The Old and New Chapter 11 Cases

The J&J companies were facing almost 40,000 claims, alleging that talc in its baby powder contained traces of asbestos. Just before the first chapter 11 filing in October 2021, the J&J parent created two new subsidiaries. LTL was created to be the debtor. It had no ongoing businesses and was given all of the talc liabilities, while the other newly created subsidiary took J&J's operating consumer businesses.

To obviate an otherwise egregious fraudulent transfer, the J&J parent and affiliates gave LTL a so-called funding agreement providing the debtor with perhaps \$61.5 billion to cover talc liabilities. Talc claimants mounted a dismissal motion, which Judge Kaplan denied in February 2022. See *In re LTL Management LLC*, 637 B.R. 396 (Bankr. D.N.J. Feb. 25, 2022). To read ABI's report on *LTL I*, [click here](#).

After the Third Circuit reversed and directed dismissal in January, the debtor unsuccessfully sought rehearing and a stay pending a petition for *certiorari* to the Supreme Court. When those



efforts failed, Judge Kaplan entered an order dismissing the first chapter 11 case, but LTL filed a second petition two hours later in Judge Kaplan's court.

The new filing was different. J&J said that the plan proposed in the second reorganization has support from at least 60,000 claimants. The J&J companies had terminated the original \$61.5 billion funding agreement. In its place, LTL has a new agreement where the parent and affiliates will fund a trust to pay chapter 11 claims.

Soon after the new filing, Judge Kaplan entered a temporary restraining order imposing a stay on talc lawsuits. The new TRO protected both LTL and potentially hundreds of other nondebtor third parties, including the J&J parent and affiliates. As required on issuance of a TRO, Judge Kaplan scheduled a preliminary injunction hearing to be held on April 18. Two days later, he issued his opinion from the bench, vacating the original TRO while imposing a more limited preliminary injunction.

On April 27, Judge Kaplan filed a 31-page written opinion, which, he said, was "intended to clarify and supplement the oral opinion."

Jurisdiction

Some talc claimants opposed the injunction and argued that Judge Kaplan should dismiss the new filing summarily. In his written opinion on April 27, Judge Kaplan first dealt with the objectors' argument that the court lacked jurisdiction to impose a stay protecting nondebtors.

Judge Kaplan ruled that the court had jurisdiction because the dispute was a "core" proceeding. He saw jurisdiction with regard to third-party injunctions resulting from indemnification obligations and "potential adverse" impacts on the estate and the prospects for reorganization.

Judge Kaplan saw "[n]othing . . . in the Third Circuit's Opinion" in *LTL II* to change his analysis in *LTL I* that the bankruptcy court has jurisdiction.

Power to Issue a Third-Party Stay

Having established jurisdiction, Judge Kaplan analyzed his statutory power to impose a stay protecting nondebtor third parties.

Judge Kaplan found statutory authority in Section 362(a)(1), because talc lawsuits could liquidate claims against the debtor. He also saw power under Section 362(a)(3), because insurance policies are estate assets.

In addition, Judge Kaplan found the requisite "unusual circumstances" required by the Third Circuit before staying actions against nondebtors.



Judge Kaplan spent the better part of his opinion addressing the propriety of an injunction under Section 105(a), which permits the court to issue “any order” that is “necessary or appropriate to carry out the provisions” of the Bankruptcy Code. To invoke Section 105(a), the debtor must show the usual four requisites for an injunction, which Judge Kaplan dealt with, one by one.

Good Faith

Regarding the good faith requirement for an injunction, Judge Kaplan said that the changed circumstances resulting from the second filing “raise more questions regarding financial distress and good faith than they answer.”

Today, Judge Kaplan said, there are more than 100,000 talc claims, more than double the initial 40,000 claims. He said that “it remains unclear whether the increased volume of claims adds to — or creates — financial distress for this Debtor.”

On the other hand, Judge Kaplan said that the debtor’s “funding sources” had been reduced from “approximately \$61 billion” to “potentially upwards of \$30 billion.” He said that “the reduction certainly appears to be manufactured . . . in direct response to the Third Circuit’s ruling.”

“Nevertheless,” Judge Kaplan said, “it is unclear whether this reduction in funding adds to — or creates — financial distress for this Debtor.”

Expounding on the decline in the funding arrangement, Judge Kaplan said that “it remains unclear whether the transactions give rise to fraudulent transfer liability for the benefit of the Debtor’s creditors.” As to actual fraud, the judge found himself “unable to conclude on this record whether there has been an actual intent to hinder, delay, and defraud creditors.”

While the issue of good faith was “undeniably” implicated by the motion to expand the stay, Judge Kaplan saw the record as “too uncertain and undeveloped for this Court to exercise its *sua sponte* dismissal authority.” He added that the question of financial distress “remains an open one for now.” Similarly, he said that “the Court cannot make a determination as to whether a fraudulent transfer occurred on this record.”

Looking to the future, Judge Kaplan said he was “skeptical and will require well-supported and timely showings by the Debtor that this reorganization continues to have a chance of success.”

Irreparable Injury and Harm to Talc Claimants

Judge Kaplan found “nothing in the Third Circuit’s decision regarding Debtor’s financial distress [that] precludes this Court from concluding that, in the present circumstances, Debtor will suffer irreparable harm if Talc Claims are allowed to proceed to trial.”



Weighing the harm to the debtor against the harm to objecting talc claimants, Judge Kaplan said that the claimants had their claims “stalled” during the first chapter 11 case and “should not lose more valuable time.” He is therefore permitting claimants to “proceed with litigation up to the point of trial.” However, he is allowing the stay “to remain in place” regarding the multidistrict litigation at least until another hearing on May 22.

Public Interest

Judge Kaplan said he “continues to believe that — assuming the bankruptcy is found to be in good faith — claim resolution through the bankruptcy process is in the public interest, especially when it is supported by the talc claimants themselves.” He also said that a settlement trust would benefit claimants “by streamlining the claim recovery process” and by protecting “the needs of future trust claimants.”

A Limited Preliminary Injunction

Judge Kaplan dissolved the TRO to allow discovery, motion practice and the filing of new suits. In place of the TRO, he imposed what he called “a far more limited preliminary injunction” to persist until June 15. The preliminary injunction will “prohibit the commencement or continuation of any trial against any of the Protected Parties.” He kept the TRO in place regarding the multidistrict litigation.

To avoid statutes of limitations from lapsing, Judge Kaplan said that the preliminary injunction would retain the injunction for unfiled claims until a claimant gives notice of intent to file suit.

Judge Kaplan will revisit the injunction once again at a hearing on May 22. In the meantime, he will conduct a status conference to set a schedule for a hearing on the motions to dismiss that have been lodged by objecting talc creditors.

Observations

The Third Circuit’s dismissal opinion in January was devoid of *dicta* suggesting whether LTL would be ineligible for bankruptcy under any other circumstances. Judge Kaplan declined to read between the lines in search of a policy hidden somewhere in the words written by Third Circuit Judge Thomas L. Ambro.

For example, Judge Ambro pointedly declined to rule on whether LTL improperly used chapter 11 as a “litigation tactic.” *LTL II, id.*, 58 F.4th at 763, fn. 19. The Third Circuit has therefore said nothing overtly to disabuse Judge Kaplan of his belief that chapter 11, compared to the tort system, represents “a more beneficial and equitable path toward resolving Debtor’s ongoing talc-related liabilities.” *LTL I, id.*, 637 B.R. at 409.



When it comes time for him to rule on the motions to dismiss the new chapter 11 case, Judge Kaplan will doubtless address the larger question of whether a family of solvent companies may invoke chapter 11 to resolve mass tort claims when they have sufficient assets to deal with the claims outside of bankruptcy.

The motions to dismiss will put J&J and LTL between a rock and a hard place. If the financial backing for the plan is more than sufficient to pay talc claims in full, the case may once again be subject to dismissal for lack of financial distress. If the financial backing is insufficient to cover claims fully, the shortfall could give rise to a multi-billion-dollar fraudulent transfer, raising the specter of dismissal for a bad faith filing.

If there is a possible fraudulent transfer, what's the standard to justify dismissal? Must the objecting creditors establish a fraudulent transfer by final judgment? Or is dismissal warranted if the objectors only show a plausible or *prima facie* claim for fraudulent transfer?

On the other hand, support for a plan by the required supermajority could breathe life into the chapter 11 case. However, confirmation of a plan might raise the question of whether dissenting creditors are entitled to opt out if the debtor is solvent.

Scholarly Commentary

"I think Judge Kaplan is being appropriately careful," Prof. Robert M. Lawless told ABI. The professor said he has "deep skepticism about LTL 2.0 and [does] not see any reasonable defense to a fraudulent transfer action. As an academic, however, my opinions need not be careful, nor do I have to provide parties due process."

Prof. Lawless continued:

This opinion is only about a temporary stay for non-debtors, and it is a limited stay that only prevents parties from going to trial and liquidating those claims. Other proceedings in the talc cases can go forward.

Judge Kaplan expresses skepticism about the bankruptcy case, saying the debtor has an "uphill battle."

LTL 2.0 is a highly visible chapter 11 case with complex, unprecedented issues. Reasonable people can differ over whether Judge Kaplan should have extended protections to the non-debtors.

It is certainly understandable, however, that Judge Kaplan took some steps to preserve the *status quo* so that the big issues in the case like good faith and



fraudulent transfers can be heard with more detailed evidence and fully briefed arguments.

Prof. Lawless is the Max L. Rowe Professor of Law and co-director of the Program on Law, Behavior & Social Science at the University of Illinois College of Law.

The opinion is *LTL Management v. Those Parties Listed on Appendix A (In re LTL Management LLC)*, 23-01092 (Bankr. D.N.J. April 27, 2023).



Adhering to the categorical prohibition of nondebtor third-party releases, the Fifth Circuit now allows a workaround to protect principal participants in chapter 11 cases.

Fifth Circuit Permits Gatekeeping to Serve the Function of Third-Party Releases

Except for the debtor, a trustee, the creditors' committee and committee members, the Fifth Circuit reiterated its categorical preclusion of nondebtor third-party releases.

However, and it's a mammoth however, the New Orleans-based appeals court sanctified a workaround to accomplish the same function as third-party nondebtor releases: A chapter 11 plan may give the bankruptcy court a gating function to approve or disapprove the commencement of lawsuits against those who would be protected by exculpations in other circuits.

The Fifth Circuit justified the gating function by relying on the venerable *Barton* doctrine, announced by the Supreme Court in 1881. *Barton v. Barbour*, 104 U.S. 126 (1881).

The August 19 opinion by Circuit Judge Stuart Kyle Duncan puts the Fifth Circuit firmly on par with Delaware and New York in terms of hospitality toward large chapter 11 cases, although Houston's recent popularity indicates that the Southern District of Texas already achieved preeminence.

The Obstreperous CEO

The debtor was a Dallas-based investment firm that managed billion-dollar publicly traded investment portfolios. The company filed a chapter 11 case in Delaware that was transferred to Dallas.

Short of appointing a chapter 11 trustee, the chief executive officer stepped down as a director and officer. In his place, the creditors' committee tapped three independent directors to act as a "quasi-trustee," Judge Duncan said. One of independent directors was a retired bankruptcy judge.

To say that the debtor's founder and former CEO was litigious is perhaps an understatement. After the former CEO filed several chapter 11 plans that failed, Judge Duncan said that "he and other creditors began to frustrate the proceedings by objecting to settlements, appealing orders, seeking writs of mandamus, interfering with [the debtor's] management, threatening employees, and canceling trades between [the debtor] and its clients."



An independent director was quoted by Judge Duncan as saying that the former CEO wanted to “burn the place down.” Later, one of the independent directors was named CEO by order of the bankruptcy court.

Well before confirmation, the bankruptcy court entered an order barring any claims against the independent directors and the new CEO “without the bankruptcy court’s authorizing the claim as a ‘colorable claim[] of willful misconduct or gross negligence,’” Judge Duncan said. The order became final without appeal.

By way of cramdown, the bankruptcy court confirmed a chapter 11 plan proposed by the independent directors.

The Exculpations and Gatekeeper Function

“Anticipating [the former’s CEO’s] continued litigiousness,” Judge Duncan said, “the Plan shields [the debtor] and bankruptcy participants from lawsuits through an exculpation provision, which is enforced by an injunction and a gatekeeper provision.”

According to Judge Duncan, the beneficiaries of the gatekeeper provision and the third-party nondebtor exculpations were “nearly all bankruptcy participants: [the debtor] and its employees and [the new] CEO; [the debtor’s sole general partner]; the Independent Directors; the Committee; the successor entities and Oversight Board; professionals retained in this case; and all ‘Related Persons.’” The oversight board was created by the plan to monitor implementation of the plan after confirmation.

Judge Duncan said that the exculpation covered any claims “in connection with or arising out of” the chapter 11 case, excluding, of course, bad faith, fraud, gross misconduct, and the like.

Judge Duncan said that the gatekeeper function barred “bankruptcy participants” from “taking any actions to interfere with the implementation or consummation of the Plan’ or filing any claim related to the Plan or proceeding.”

Should someone intend to assert a claim against “protected parties, it must go to the bankruptcy court to ‘first determin[e], after notice and a hearing, that such claim or cause of action represents a colorable claim of any kind,’” Judge Duncan said. “Only then,” he went on to say, “may the bankruptcy court ‘specifically authoriz[e]’ the party to bring the claim.”

Judge Duncan said that the “Plan reserves for the bankruptcy court the ‘sole and exclusive jurisdiction to determine whether a claim or cause of action is colorable’ and then to adjudicate the claim if the court has jurisdiction over the merits.”

Equitable Mootness



The former CEO and others appealed. Because the plan had been consummated, the debtor moved to dismiss the appeal as equitably moot.

After laying out the elements of equitable mootness recognized by circuits around the country, Judge Duncan said that the invocation of the doctrine “turns on whether the court can craft relief for that claim that would not have significant adverse consequences to the reorganization.”

Citing *In re Pacific Lumber Co. (Pacific Lumber)*, 584 F.3d 229, 252 (5th Cir. 2009), Judge Duncan said that equitable mootness “does not bar our review” of third-party releases. Again citing *Pacific Lumber*, he said that equitable mootness does not prevent an appellate court from examining application of the absolute priority rule.

Third-Party Releases on the Merits

Summarizing, Judge Duncan said that the plan “exculpates certain non-debtor third parties supporting the Plan from post-petition lawsuits not arising from gross negligence, bad faith, or willful or criminal misconduct.” He described the gatekeeper provisions as requiring “the bankruptcy court’s approval of the claim” before “any lawsuit is filed.”

“Together,” Judge Duncan said, the plan provisions prohibit “bad-faith litigation” that “could disrupt the plan’s effectiveness.”

Both sides agreed that *Pacific Lumber* controlled and that exculpation for the debtor and the committee were permissible. According to the debtor, the broader exculpations were “a commonplace Chapter 11 term” that “merely provides a heightened standard of care.”

Judge Duncan acknowledged that there is a circuit split, placing the Fifth Circuit at odds with other circuits condoning nondebtor third-party releases. He characterized the Fifth Circuit as being in league with the Tenth Circuit by “categorically bar[ring] third-party exculpations absent express authority in another provision of the Bankruptcy Code.”

Judge Duncan said that other laws permitting exculpations were Section 524(g), applicable to “asbestos” cases, and the qualified immunity conferred on trustees and creditors’ committees. He went on to “reject[] the parsing between limited exculpations and full releases that Highland Capital now requests.”

The bankruptcy court’s findings of fact about the need for insulating the plan and its participants from the predations of the former CEO “do not alter whether it has statutory authority to exculpate a non-debtor,” Judge Duncan said.



The independent directors were playing a unique role in the case. Judge Duncan said they were “appointed to act together as the bankruptcy trustee” for the debtor. As such, he said, they are “entitled to all the rights and powers of a trustee” and “to the limited qualified immunity for any actions short of gross negligence.”

Judge Duncan struck provisions in the plan providing exculpations for anyone other than the debtor, the creditors’ committee and its members for conduct within the scope of their duties, and the independent directors. In other words, he excised exculpations in favor of the debtor’s employees, the new CEO, the general partner, the trust created by the plan, the professionals for the debtor and the committee, the plan’s oversight board and “related persons.”

Gatekeeping Ok’d

Having eviscerated exculpations that are commonplace in other circuits, Judge Duncan said that the “injunction and gatekeeper provisions are, on the other hand, perfectly lawful.” Citing the *Barton* doctrine, he said that “[c]ourts have long recognized [that] bankruptcy courts can perform a gatekeeping function.”

The appellants argued that the gatekeeping function extended to claims not within the bankruptcy court’s jurisdiction. Judge Duncan saw no need to “evaluate whether the bankruptcy court would have jurisdiction under every conceivable claim falling under the widest interpretation of the gatekeeper provision. We leave that to the bankruptcy court in the first instance.”

Judge Duncan went on to say in a footnote that the opinion should not be interpreted “to hinder the bankruptcy court’s power to enjoin and impose sanctions on [the former CEO] and other entities by following the procedures to designate them vexatious litigants.”

Another Protection Left Standing

Well before confirmation, the bankruptcy court had entered an order barring claims against the independent directors and the new CEO without the court’s approval. The order was not appealed and became final.

The circuit court had no jurisdiction to entertain a collateral attack on that order, Judge Duncan said. To the extent the appellants sought to “roll back the protections [in that order],” he said that “such a collateral attack is precluded.”

The finality of the order was a big deal. Judge Duncan said that it had “the effect of exculpating the Independent Directors and [the new CEO] in his executive capacities.”

The mid-case order was even more expansive. Judge Duncan said that it gave *res judicata* protection to the independent directors’ agents, advisors and employees.



Chapter 11 Issues on the Merits

Judge Duncan upheld the bankruptcy court on the merits of issues regarding plan confirmation.

The former CEO contended there was a violation of the absolute priority rule by giving out-of-the-money paper to two classes of unsecured creditors. Judge Duncan said that absolute priority “has never required us to bar junior creditors from ever receiving property.”

Judge Duncan also saw no clear error in the bankruptcy court’s voluminous findings of fact to justify confirmation of the plan.

[The opinion is](#) *NexPoint Advisors LP v. Highland Capital Management LP (In re Highland Capital Management LP)*, 21-10449 (5th Cir. Aug. 19, 2022).



Bound by Dow Corning, which permitted nondebtor releases, the Sixth Circuit had to explain why the same releases are not permissible in equity receiverships.

Sixth Circuit: Nondebtor Releases Are Ok in Chapter 11 but Not in Receiverships

The Sixth Circuit banned district courts from granting nondebtor releases in equity receiverships. More precisely, the Cincinnati-based appeals court ruled that an equity receivership cannot stop creditors from pursuing their direct claims (as opposed to derivative claims) against nondebtors.

The rationale was simple: Nondebtor releases were previously unknown to equity jurisprudence. As a result, the circuit said that an equity receivership cannot protect the non-receivership assets of non-receivership parties.

Most insolvencies end up in chapter 11, so the February 7 opinion may have limited practical application. Still, the February 7 opinion is food for thought: Is the Sixth Circuit an example of growing antipathy by Article III judges toward nondebtor releases, even in chapter 11 cases? Does the opinion suggest that the Sixth Circuit may revisit or limit its own decision that allowed nondebtor releases in *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002)?

The Bankruptcy that Wasn't in Bankruptcy

The nonprofit debtor purchased and for a short time operated three “university” systems with dozens of campuses. The venture soon became insolvent. The debtor contended that the for-profit seller had misrepresented revenues and expenses.

Students filed a class action against the debtor and its officers and directors, alleging that the debtor represented that it was accredited when the accreditation had been lifted. The suit alleged fraud.

A creditor owed \$250,000 filed a diversity action in federal district court in Ohio, seeking appointment of a receiver. The debtor “quickly consented” to the receivership, Circuit Judge Eric E. Murphy said.



Why not chapter 11 instead of a receivership? Judge Murphy explained how the debtor believed that bankruptcy would cut off its income because students would be unable to take down federal loans to pay tuition.

The debtor's assets included directors' and officers' liability insurance policies. The receiver negotiated a settlement for the insurer to pay \$8.5 million, the unused portion of coverage provided by a D&O policy. The receiver justified the settlement by saying that the receivership estate had claims against the policy.

There was a hitch, though: The insurance company wanted a so-called bar order preventing creditors from suing based on the policy. The receiver agreed. As consolation for the class plaintiffs, the settlement allowed the class claimants to file claims in the receivership.

As ultimately drafted, the bar order enjoined creditors, including the class plaintiffs, from suing not only the debtor but also the nondebtor parent, officers and directors and the insurance company. The class plaintiffs objected, but the district court approved the settlement and the bar order. The class plaintiffs appealed to the circuit and won.

The History of Equity Receivers

Judge Murphy said that the case presented a legal question: Did the district court have "power to enter the Bar Order that enjoined the [class plaintiffs'] claims not just against the *receivership entities* . . . but also against *third parties outside the receivership*"? [Emphasis in original.]

To answer the question, Judge Murphy traced the history of equity receiverships going back 500 years in England and the refinements in the U.S. in later decades. The opinion is worth reading as a refresher course on the jurisdiction and powers underlying equity receiverships.

Judge Murphy said that equity receiverships "remain a reorganization option" for companies that otherwise could file bankruptcy petitions.

Today, Judge Murphy said, equity receiverships are governed by Federal Rule 66, which says that "the practice in administering an estate by a receiver or similar court-appointed officer must accord with the historical practice in federal courts or with a local rule."

Citing the Supreme Court's decision in *Grupo Mexicano de Desarrollo S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 318-319, 322 (1999), Judge Murphy said that "a federal court's exercise of its equitable powers must fall within the traditional principles of equity exercised by the High Court of Chancery in England at the founding."

Judge Murphy explained that the court in an equity receivership has *quasi in rem* jurisdiction over the corporate debtor and its property. Over the *res*, the jurisdiction is exclusive, he said. The



court therefore “could issue a variety of injunctions to protect its exclusive jurisdiction over the debtor’s property.” In addition, the receiver has power to bring claims held by the debtor.

Judge Murphy turned to the limitations on a receiver’s power. If there could be no effect on receivership property, there could be no injunction. Indeed, the receivership court could not enjoin suit against a debtor if it sought only an *in personam* judgment and did not threaten receivership property.

The Principles Applied to the Case on Appeal

The class plaintiffs had fraud claims against non-receivership entities and individuals. In fact, the claims were not covered by the insurance policy because the policy excluded claims for fraud. Consequently, the class claims did not threaten to diminish the policy proceeds. Judge Murphy had no reason to decide whether insurance proceeds were estate property, because the class claims would not become a charge against the policy.

Judge Murphy concluded that the class fraud claims were not derivative of the claims that the receiver would have against the directors and officers. The claims did not represent “injuries that [the class] incurred indirectly as a result of a harm that the directors and officers caused [the debtor].” Thus, the class claims were “direct” claims belonging to the class members.

In sum, the class claims belonged to the class alone and did not threaten to invade insurance proceeds. Judge Murphy said that the court might have issued a narrow injunction preventing the insurance company from paying defense costs in the class suit, but the “Bar Order, in enjoining all personal-liability claims against [the debtor’s] directors and officers, went far beyond this narrow property-protective injunction.”

The Analogy to Chapter 11 Nondebtor Injunctions

Judge Murphy said that “[o]ur bankruptcy precedent confirms that the Bar Order cannot stand on traditional equity principles.” He cited the Fifth and Tenth Circuits for prohibiting injunctions to protect nondebtors.

Citing *Dow Corning*, Judge Murphy said that his circuit was among those protecting nondebtors. Those injunctions, he said, “have obtained a judicial foothold only in the last several decades.”

“The relative recency of this innovation provides strong evidence that it lacks roots in ‘the principles applied by the English Court of Chancery before 1789, as they have been developed in the federal courts,’” he said, citing *Grupo Mexicano*.



Judge Murphy justified *Dow Corning's* injunction prohibiting suit against nondebtors as having been based on Section 105 of the Bankruptcy Code. For equity receiverships, on the other hand, he implied that there is no Section 105 counterpart.

Having distinguished *Dow Corning*, Judge Murphy reversed the order approving the settlement and the bar order because a court of equity could not have granted that type of relief.

The opinion is *Dugan v. South University of Ohio LLC (In re Digital Media Solutions LLC)*, 21-4014 (6th Cir. Feb. 7, 2023).



Upholding confirmation of the Boy Scouts' chapter 11 plan, the district judge in Delaware disagreed with his counterpart in New York who found no statutory power to impose non-consensual, non-debtor third-party releases.

Delaware and New York District Courts Split on Permissibility of Non-Debtor Releases

District Judges in New York and Delaware disagree about the ability of a debtor to confirm a chapter 11 plan with non-consensual, non-debtor third-party releases.

In September, the bankruptcy court in Delaware confirmed the chapter 11 plan for Boy Scouts of America containing non-consensual, non-debtor third-party releases. In a 155-page opinion on March 28, District Judge Richard J. Andrews upheld confirmation, observing that the Third Circuit “and other courts have repeatedly recognized the statutory authority of bankruptcy courts to issue nonconsensual third-party releases under appropriate circumstances.”

Coming out the other way, District Judge Colleen McMahon of New York vacated confirmation of the Purdue Pharma LLP chapter 11 plan in December 2021, holding that the bankruptcy court has no statutory power to impose non-consensual releases of creditors’ direct claims against non-debtor third parties. *In re Purdue Pharma LP*, 635 B.R. 26 (S.D.N.Y. Dec. 16, 2021). To read ABI’s report on *Purdue*, [click here](#).

The debtor appealed to the Second Circuit. Oral argument was held on April 29, 2022. The appeal remains *sub judice*.

The Biggest Ever

Judge Andrews said that the “global resolution” of the BSA case created “the largest sexual abuse compensation fund in the history of the U.S.” The product of mediation, the trust created by the plan will have not less than \$2.6 billion in cash and property plus insurance rights that could be worth another \$4 billion.

All sexual abuse claims are “channeled” into the trust. In addition to the debtor, the plan affords releases to related entities not in bankruptcy, local Boy Scout councils and other organizations, and entities covered by insurance policies issued by insurers who settled with the debtor.



More than 80,000 claims were filed, making the case “extraordinary,” according to Judge Andrews. The plan was accepted by about 85% of abuse claimants, along with “every estate fiduciary and nearly every organized creditor group,” the judge said.

Not settling, several insurance companies filed objections to the plan and appealed confirmation. Clients of two law firms also appealed confirmation.

Established Law Permits Releases

The appellants raised a multitude of allegations of error en route to plan confirmation. We shall focus on the non-debtor releases that were designed to protect, among others, local scout groups, insurance companies and individuals.

The appellants contended there is no statutory authority for a plan to include non-consensual releases. “They are wrong,” Judge Andrews said, citing *In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000). For 20 years after *Continental Airlines*, he said that the Third Circuit and courts within the circuit have “permitted nonconsensual third-party releases in narrow circumstances where the releases are fair and necessary to the reorganization.

Like the bankruptcy judge who was reversed in *Purdue*, Judge Andrews found statutory power through a combination of Sections 105(a), 1123(a)(5) and 1123(b)(6). Citing *U.S. v. Energy Res. Co.*, 495 U.S. 545, 549 (1990), he said that those sections gave the court “residual authority” to confer “relief not specifically authorized elsewhere in the Bankruptcy Code.”

With regard to the New York district judge’s belief that there is no power in the statute, Judge Andrews said that her “decision departs from existing Second Circuit precedent, which, like the Third Circuit, holds that bankruptcy courts are authorized to enjoin and release third-party claims against non-debtors where such releases are integral to the debtor’s reorganization.”

Also in distinction to the New York district judge, Judge Andrews said that Section 524(g), permitting non-debtor releases in asbestos cases, “does not render such releases impermissible in non-asbestos cases.” He supported his conclusion about implications from Section 524(g) by quoting legislative history to the effect that the addition of the section does not impair or supersede any other authority for the issuance of injunctions.

Having found no blanket prohibition for non-debtor releases, Judge Andrews proceeded to rule that the BSA plan and the bankruptcy court’s findings satisfied the “hallmarks” required by *Continental Airlines*. Finding that the injunctions were necessary to the reorganization and were fair, he upheld confirmation.

Note: Objectors filed a motion in district court for a stay pending appeal, to prevent the appeal from becoming moot by consummation of the plan.



The opinion is *National Union Fire Insurance Co. of Pittsburgh v. Boy Scouts of America (In re Boy Scouts of America)*, 22-1237 (D. Del. March 28, 2023).



If you want a prejudgment asset freeze, ask for equitable relief and the recovery of specific property, Judge Goldblatt says.

Delaware Judge Says When Prejudgment Asset Freezes Are Ok Under *Grupo Mexicano*

English courts since 1975 have issued so-called *Mareva* injunctions to prohibit defendants from transferring assets before judgment. See *Mareva Compania Naviera S. A. v. International Bulkcarriers S. A.*, 2 Lloyd's Rep. 509.

In his January 31 opinion, Bankruptcy Judge Craig T. Goldblatt of Delaware explained how the Supreme Court in 1999 barred the use of *Mareva* injunctions in the U.S. by holding "that a federal court may not freeze a defendant's assets when the plaintiff asserts what is only a legal claim against the defendant." See *Grupo Mexicano de Desarrollo S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 333 (1999).

In the case before Judge Goldblatt, the bankruptcy trustee had mounted a fraudulent transfer action against multiple defendants seeking the recovery of millions of dollars in property. Although a fraudulent transfer action is typically seen as an action at law, Judge Goldblatt decided that he had authority to enter a preliminary injunction freezing some of the defendants' assets because the trustee was seeking the return of specific property and was also asking for equitable relief in the form of an accounting.

Bad Facts

Before even considering whether *Grupo* would prohibit freezing the defendants' assets, Judge Goldblatt was obliged to determine whether the facts would justify a preliminary injunction. As it turns out, the facts were sufficient.

The debtor was a government contractor. Before bankruptcy, several creditors had obtained judgments against the debtor for about \$6.3 million. The debtor filed a chapter 11 petition when the creditors were commencing supplemental proceedings to locate and attach assets.

The creditors filed a motion to dismiss or convert to chapter 7. Given several "bad facts" that came out at the hearing, Judge Goldblatt was prepared to dismiss or convert. At the creditors' behest, he converted the case to chapter 7.



The chapter 7 trustee filed suit against several insiders for recovery of fraudulent transfers, breach of fiduciary duty, constructive trust and an accounting. Immediately, the trustee filed a motion for a preliminary injunction to freeze the defendants' assets.

Judge Goldblatt's 35-page opinion details some of the bad facts that came out during the conversion and injunction hearings and previously in litigation in Florida state court. He said that some of the debtor's business records had been "fabricated" or altered. He recounted how the state court had "pointed out that the debtor had made a number of substantial prepetition transfers to its insiders and, more troubling, had taken steps to conceal the fact of those transfers." In addition, there was false, sworn testimony and no evidence that the debtor was on the cusp of collecting a claimed \$20 million receivable from the government.

The bankruptcy trustee discovered other allegedly bad facts after his appointment. Judge Goldblatt said that newly discovered evidence "suggests that the debtor's fabrication of business records and concealment of transfers to insiders was more prevalent than the Court had previously appreciated based on the prior hearings."

The Loophole in *Grupo*

Judge Goldblatt's opinion is required reading for anyone pursuing an injunction to freeze defendants' assets. In detail, he describes what *Grupo* prohibits and what it allows in terms of asset freezes.

In brief, Judge Goldblatt described *Grupo* as holding "that a federal court may not freeze a defendant's assets when the plaintiff asserts what is only a legal claim against the defendant." On the other hand, the Supreme Court said "that such an injunction *is* available in a case in which the plaintiff seeks equitable relief." [Emphasis in original.]

In addition, Judge Goldblatt cited authority for the notion "that courts have greater authority to freeze assets for the benefit of a creditor that has obtained a judgment." Suffice it to say, he explained historically why the distinction between legal and equitable relief determines whether a plaintiff can be entitled to an asset freeze.

When the plaintiff seeks equitable relief like an accounting, Judge Goldblatt said that the limitation on the court's authority under *Grupo* "has no application." In fact, "a plaintiff seeking equitable relief need not show that the specific asset it seeks to freeze is one in which the plaintiff has an interest."

Alongside *Grupo*, Judge Goldblatt parsed *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989), where the Supreme Court said that a fraudulent transfer suit may sound in both law and equity, depending on the relief being sought by the plaintiff.



The trustee’s motion to freeze real property “is permitted,” Judge Goldblatt said, “since the claim to require the return of that real estate sounds in equity.” In contrast, the motion to freeze cash “is more controversial.”

Judge Goldblatt decided that a freeze on cash “is nevertheless permitted . . . because in addition to seeking to recover the value of that cash as a fraudulent conveyance, the complaint also includes a claim for an accounting of the disposition of that cash.” He buttressed his conclusion by citing *Granfinanciera* for holding that an “accounting is an equitable remedy.”

Summing up, Judge Goldblatt held:

[W]here a plaintiff in a fraudulent conveyance action seeks *either* to recover a specific asset (such as real estate) *or* requires an accounting, such a claim would be viewed as sounding in equity, and thus fit within the equitable exception described in *Grupo Mexicano* And because the plaintiff here seeks an accounting, this Court concludes that it has the authority to impose an asset freeze in this case. [Emphasis in original.]

Having found authority for an asset freeze, Judge Goldblatt turned to the question of whether the trustee had shown the requisites for a preliminary injunction.

P.I. Standards Satisfied

Judge Goldblatt found “a reasonable probability of success on the merits,” because badges of fraud were “amply present.” While purely economic injuries ordinarily do not justify injunctive relief, Judge Goldblatt found irreparable harm because the “defendants may move or conceal assets.”

To justify issuance of an injunction, Judge Goldblatt found that an “appropriately tailored” injunction would not “unduly prejudice” the defendants and that the public interest favored granting an injunction.

Rather than imposing a blanket asset freeze, Judge Goldblatt adopted a “surgical” approach by limiting the freeze to the extent of valid claims against the estate. To prevent the freeze from being “punitive,” he carved out enough “for ordinary course expenditures.” He allowed the trustee to obtain the injunction without a bond under Bankruptcy Rule 7065.

The opinion is *Miller v. Mott (In re Team Systems Int. LLC)*, 23-50004 (Bankr. D. Del. Jan. 31, 2023).



Judge Graham in Indianapolis sees the Seventh Circuit as interpreting 'related to' jurisdiction narrowly and not inclined to halt lawsuits against nondebtors without a direct effect on the bankrupt estate.

Judge Predicts Seventh Circuit Wouldn't Halt Earplug Lawsuits Against Nondebtor 3M

Betting that the Seventh Circuit would create a circuit split on the facts of the case before him, Bankruptcy Judge Jeffrey J. Graham of Indianapolis refused to expand the automatic stay to cover 3M Corp., the nondebtor parent of a company in chapter 11 dealing with the largest mass torts ever to hit the federal courts.

Judge Graham's August 26 opinion could be read to mean that he might have protected the nondebtor parent with an expanded stay had pre-filing financial arrangements been written differently.

Beginning in 2000, the debtor made earplugs for the military. 3M acquired the debtor in 2008. Two years later, the debtor's businesses were "upstreamed" to 3M in return for a \$965 million payable to the debtor. Judge Graham said that 80% of the sales of the earplugs occurred before the upstreaming. He said it was "unclear" whether 3M assumed any liabilities as part of the upstreaming.

In settlement of a *qui tam* action, 3M paid \$9.1 million to the government on account of allegedly defective earplugs.

Then, the lawsuits began. By the time the debtor filed a chapter 11 petition in late July, there were 290,000 claims covered by multidistrict litigation in Florida, where the debtor and 3M are co-defendants. In addition, Judge Graham said there are 2,000 more suits in state court in Minnesota, where 3M is headquartered.

The debtor, by the way, is also a Delaware corporation like 3M but is headquartered in Indianapolis.

Judge Graham said that the multidistrict litigation is the largest in history and represents 30% of all civil cases currently pending in federal courts.

There already have been several bellwether trials. 3M and the debtor won six of them, but the plaintiffs won 12, yielding verdicts ranging between \$1.7 million and \$77.5 million.



Before the subsidiary's chapter 11 filing, independent directors for the debtor negotiated a financial arrangement with 3M. The complex arrangement committed 3M to a \$240 million fund for the chapter 11 process plus an uncapped commitment to fund a trust to cover claims.

The debtor is obligated to indemnify 3M for whatever it spends, but the debtor can cover its liability by drawing funds from 3M. Judge Graham said that the "net effect to [the debtor] is zero."

The P.I. Motion

On filing in chapter 11, the debtor began an adversary proceeding and sought a preliminary injunction. The debtor wanted Judge Graham to rule that the Section 362(a) automatic stay covered 3M or, alternatively, that the debtor wanted Judge Graham to protect 3M with an injunction made under Section 105(a).

Claimants objected to an expansion of the automatic stay. Judge Graham denied the initiative in a 37-page opinion.

Before delving into the merits, Judge Graham said the chapter 11 is not "the *only* avenue" for achieving a "global settlement." [Emphasis in original.] He also said that he was not deciding whether the chapter 11 filing was in good faith.

The debtor and 3M are also facing a separate spate of lawsuits alleging that respirators made by the debtor were defective. The respirator lawsuits are substantial but pale in comparison to the earplug suits. Judge Graham barely mentioned the respirators.

By the way, the 3M parent was not a party in the debtor's attempt at halting lawsuits against it.

Section 362(a)(1)

First, Judge Graham dealt with the debtor's contention that Section 362(a)(1) automatically stopped lawsuits against the parent. The section halts the commencement or continuation of actions against the debtor.

Working from the proposition that the automatic stay "generally protects only the debtor," Judge Graham said he was "reluctant to conclude that Section 362(a)(1), standing alone, offers sufficient statutory authority to conclude that the Pending Actions are stayed automatically as to 3M or to extend the protections of the stay to 3M."

Citing the Fourth Circuit's 1987 decision in *A.H. Robbins*, Judge Graham admitted "there is ample case law holding otherwise."



Bound by precedent from the Seventh Circuit, Judge Graham said that his court of appeals “has not, to date, expansively discussed or formally adopted *A.H. Robbins* in this regard.... Nor has the Circuit actually extended the stay to a non-debtor party under that reasoning.”

“Without more guidance from the Seventh Circuit,” Judge Graham declined to extend Section 362(a)(1) to cover 3M.

Section 362(a)(3)

Next, Judge Graham turned to Section 362(a)(3), which bars “any action” to obtain property of or from the estate. It is “broader than just the debtor,” the judge said, and entails a two-step analysis. First, is property of the estate at issue, and, second, does the action threaten to obtain or exercise control over estate property?

Judge Graham assumed that insurance policies held by the debtor and 3M were estate property. On the question of obtaining property of or from the estate, he saw “no evidence” that the claimants were “proceeding directly against the insurance policies.”

Judge Graham next analyzed whether the suits were an indirect attempt at glomming the insurance policies. He found no violation of Section 362(a)(3) because the funding agreement signed just before bankruptcy means that “3M will fully fund any liability incurred” by the debtor. Given the uncapped backstop by 3M, tapping insurance policies would not affect how much creditors receive or cause an inequitable distribution among creditors.

Section 105(a)

The debtor was left with arguing that Judge Graham should expand the stay to cover 3M under Section 105(a), which gives the court power to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

Citing the Seventh Circuit, Judge Graham said that the court may stay actions that may affect the amount of property in the bankrupt estate. But first, he said, the court must have “related to” jurisdiction to stay lawsuits pending in state court and in the multidistrict litigation.

Regarding “related to” jurisdiction, Judge Graham said that the Seventh Circuit has taken a “more constrained approach” and said that it must be interpreted “narrowly.” Again citing the Seventh Circuit, he said that “related to” jurisdiction requires “a direct effect” on either the estate or the distribution to creditors.

Looking for a direct effect on the estate, Judge Graham discounted the debtor’s obligation to indemnify 3M because the funding agreement “provides for an uncapped, non-recourse



commitment from 3M to fund all of the [debtor's] liabilities" and was not conditioned on obtaining a stay to protect 3M. He was therefore "unable to discern any financial impact to creditors."

"A number of other courts have extended the stay notwithstanding the existence of an uncapped funding agreement," Judge Graham said. "Respectfully, this Court cannot follow suit," because the Seventh Circuit instructed courts to focus "on the *actual* economic effect" that continuation of the suits would have on the estate. [Emphasis in original.]

Judge Graham gave short shrift to the idea that continuation of the suits would be a "significant" distraction." He put "little stock on this claim."

In short, Judge Graham saw no "related to" jurisdiction that would enable him to issue an injunction under Section 105(a). Even if there were jurisdiction, he said he "would reach the same conclusion" because a stay under Section 105(a) "should issue only in extraordinary circumstances" necessary to carry out other provisions of the Bankruptcy Code.

At the end of his opinion, Judge Graham admitted that a stay might give 3M and the debtor "additional leverage" to "negotiate a global settlement."

"Alas," Judge Graham said, "those questions are not things to be considered" under Section 362 or in deciding whether there is jurisdiction under Section 105(a).

Judge Graham sustained the objections and denied the motion for a preliminary injunction.

Note: The debtor is pursuing a direct appeal to the Seventh Circuit.

Observations

The opinion reminds this writer of basketball: no harm, no foul.

Further trials absent an expanded stay may well deplete insurance coverage and result in a clear effect on the estate, but Judge Graham saw no harm given 3M's uncapped commitment. If it were shown as a matter of fact that 3M won't be able to cover all damages, would Judge Graham have expanded the stay under Section 362(a)(3)?

Plaintiffs would not argue that 3M is insolvent and thereby open the door to a broader stay. To avoid damaging stockholders, 3M likewise would not claim insolvency.

So, 3M might have won an expanded stay were the commitment not uncapped, but uncapping the commitment would expose the debtor to a better argument about a bad faith filing. Thus, 3M was between a rock and a hard place.



The case raises the question of whether the U.S. legal system as currently configured — be it the tort system or bankruptcy — is adequately designed for dealing with massive tort claims threatening to destroy an otherwise profitable company employing thousands of workers. Were Congress to begin drafting a solution, any legislation would inevitably favor one side or the other. Proposing legislative action seems like voluntarily stepping on the third rail.

The fact that 3M won't have an expanded stay at this juncture does not preclude the possibility of a settlement to be effected through a traditional class action. Perhaps we should sit back and wait to see whether companies like 3M can survive without an expanded stay.

The foregoing are this writer's thoughts and do not represent the opinions of ABI.

[The opinion is](#) *3M Occupational Safety LLC v. Those Parties Listed on Appendix to the Complaint (In re Aearo Technologies LLC)*, 22-50059 (Bankr. S.D. Ind. Aug. 26, 2022).



When the debtor files bankruptcy before the time has elapsed for a creditor to file a cross appeal, the cross appeal is deemed timely when filed within 30 days after the stay terminated, the Tenth Circuit held.

A Bankruptcy Petition Automatically Stays the Filing of an Appeal or a Cross Appeal

The filing of a bankruptcy petition tolls the time for both the debtor and a creditor to file a notice of appeal or a cross appeal in a suit that was pending at the time of filing, according to the Tenth Circuit.

A manufacturer of nutritional supplements sued a competitor for false advertising in violation of the Lanham Act and similar Utah state law. After a bench trial, the district court found violations of state and federal law and entered a \$9.5 million judgment in favor of the plaintiff, plus attorneys' fees for discovery violations.

The district court denied the plaintiff's request for punitive damages and an injunction.

The defendant filed a notice of appeal, followed a few days later by a chapter 11 petition. After the automatic stay was dissolved, the plaintiff quickly filed a cross appeal.

The plaintiff had filed its cross appeal more than one year after the debtor had filed the initial appeal. Under F.R.A.P. 4(a)(3), the plaintiff's cross appeal was due within 14 days after the defendant had appealed. Was the cross appeal timely? Did the appeals court have jurisdiction with regard to the cross appeal?

The plaintiff argued that the automatic stay in Section 362(a) precluded the filing of a cross appeal until the stay terminated.

Tenth Circuit Judge David M. Ebel first quoted Section 362(a)(1), which says that the filing of the petition "operates as a stay" of "the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case"

"If there is a pending non-bankruptcy deadline when the stay takes effect," Judge Ebel said, "this deadline is tolled until the later of either 'the end of such period' or '30 days after notice of the termination or expiration of the stay,'" citing Section 108(c)(1)(2).



Judge Ebel was persuaded by the Eighth Circuit, which, he said, had held that “an appeal . . . in a case in which the debtor originally was the defendant is a “continuation” of a “proceeding against the debtor”” such that § 108(c) tolls the deadline of an appeal against a debtor.” *In re Hoffingers Inds., Inc.*, 329 F.3d 948, 952 (8th Cir. 2003).

“This makes sense,” Judge Ebel said, citing the *Norton* treatise.

“This core purpose would plainly be frustrated if a creditor could engage a debtor on appeal during the stay period,” Judge Ebel said. He went on to observe that “this conclusion accords with our precedent, as we have held that the automatic stay bars even a debtor in bankruptcy from appealing an adverse judgment.”

“If a *debtor* cannot appeal an adverse judgment during the bankruptcy stay, then surely a *creditor* is not permitted to file an appeal when a stay is in place,” Judge Ebel said. [Emphasis in original.]

Judge Ebel held “that filing a cross-appeal constitutes the ‘commencement or continuation’ of a judicial action or proceeding, and so the deadline to file a cross-appeal is tolled by § 108(c)(2) during a bankruptcy proceeding of the cross-appellee.” Because the plaintiff had cross appealed fewer than 30 days after the stay terminated, he held that the cross appeal was timely.

The appeals court upheld the judgment of liability under federal and state law together with the assessment of attorneys’ fees. The circuit further ruled in favor of the plaintiff by remanding for the district court to decide whether the plaintiff was entitled to punitive damages and an injunction.

[The opinion is](#) *Heartwise Inc. v. Vitamins Online Inc.*, 20-4126 (10th Cir. June 27, 2023).



False advertising that violates non-bankruptcy law isn't necessarily a violation of the automatic stay, New York district judge says.

Misleading Advertising to Poach a Debtor's Customers Is No Stay Violation

Reversing the bankruptcy court and setting aside \$19 million in sanctions, a district judge in New York handed down an opinion on October 6 that could be read to mean that misleading advertising designed to poach a debtor's customers does not violate the automatic stay.

The debtor, a provider of commercial and residential communications services, filed a chapter 11 petition to reorganize. A competitor mounted a direct mail campaign targeting the debtor's customers.

The competitor's advertising announced that the debtor was in chapter 11 and asked whether the debtor would be able to stay in business. For example, the advertising said that the debtor's future was "unknown" and insinuated that the debtor might cease providing services.

Alleging that the advertising was "knowingly false" and caused "confusion" among its customers, the debtor filed an adversary proceeding in bankruptcy court contending that the competitor had violated the automatic stay.

On summary judgment, the bankruptcy court held that the competitor's advertising violated the automatic stay in Section 362(a)(3) as "an act to control property of the estate, namely, the debtors' customers or contracts with those customers." After trial, the bankruptcy court issued an order imposing almost \$19.2 million in sanctions for a "literally false and intentionally misleading advertising campaign that wrongfully interfered with the Debtors' customer contracts and goodwill."

District Judge Cathy Seibel reversed on appeal. Sitting in White Plains, N.Y, she analyzed whether the advertising violated the automatic stay and whether, under *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), there was a "fair ground of doubt" about the advertising as a stay violation.

Control over Estate Property

Although she found the evidence to be "quite thin," Judge Seibel said that the bankruptcy court "did not clearly err in concluding that [the debtor] had some kind of contracts under which it provided services to at least some customers." However, she went on to explain why the



“advertisements were not acts to ‘obtain’ or ‘control’ any such contracts,” even if the debtor’s goodwill was also protected by the automatic stay.

The governing statute, Section 362(a)(3), proscribes “any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate.” Judge Seibel said that the “plain language of this statute does not clearly encompass solicitation of a debtor’s customers, which one does not typically regard as ‘exercising control’ over ‘property.’”

Judge Seibel went on to say that “there is nothing in the ‘plain terms’ of § 362(a)(3) that suggests that ‘improper’ advertisements are methods of ‘control’ but ‘legitimate’ ones are not.” She said that “[t]he *statute does not prohibit all conduct that harms or interferes with a debtor’s business*, but only that which amounts to an effort to obtain or control estate property.” [Emphasis added.]

Even if the competitor’s advertising violated non-bankruptcy laws, Judge Seibel said it was “not clear how it was an act to ‘exercise control’ over contracts or goodwill.” She added that it was not correct to say that “any attempt to compete with an entity going through reorganization would be stayed, whether wrongful or not.”

Focusing on the language of the statute, Judge Seibel said,

[T]he customer is not property of the estate. It is thus difficult to see how, without more, influencing or manipulating a customer to opt for a competitor’s service over a debtor’s through advertisements, false or otherwise, is an act of control over estate property.

In other words, Judge Seibel said, “The mere fact that the conduct may be wrongful or unlawful does not automatically convert it into a violation of the automatic stay.”

Judge Seibel found no stay violation because the “advertisements cannot reasonably be seen as an act to exercise control over property of [the debtor’s] estate.”

Taggart Issues

Even if there were a stay violation, Judge Seibel asked whether there was a “fair ground of doubt” about a stay violation to exonerate the competitor under *Taggart, supra*, 139 S. Ct. 1799, 1801.

Judge Seibel quoted the bankruptcy court for saying, in substance, that someone in doubt about whether an act would violate the stay should first seek a so-called comfort order from the bankruptcy court. She said that *Taggart* rejected a “substantially similar standard” under Section 105(a).



Although there are differences between the discharge injunction in *Taggart* and the automatic stay in the case on appeal, Judge Seibel said it was “contrary to *Taggart* to read into § 105(a) a requirement that a creditor ‘seek clarification from the court or be sanctioned for shooting first and aiming later’ if the creditor is unsure whether its contemplated course of conduct would run afoul of the automatic stay.” She therefore held that “there is no requirement that the would-be violator move to lift the stay prior to acting.”

Because it was “at least highly debatable” whether the advertising amounted to an attempt to “exercise control” over estate property, Judge Seibel held that the bankruptcy court abused its discretion by holding the competitor in contempt. She vacated the contempt citation and the \$19.2 million sanction.

It Ain't Over Yet

The competitor is not out of the woods.

The debtor had also sued the competitor in bankruptcy court for violating the Lanham Act and state law equivalents. Judge Seibel had withdrawn the reference.

Despite the reversal of the contempt finding, Judge Seibel said that the debtor “still may pursue its false advertising and breach of contract claims.”

[The opinion is](#) *Holdings Inc. v. Charter Communications Inc. (In re Windstream Holdings Inc.)*, 21-4552 (S.D.N.Y. Oct. 6, 2022).



Retention & Compensation



Following the Model Rules and erecting ethical screens allows adversary lawyers to date and marry.

Marrying an Adversary Doesn't Mean Disqualification, Third Circuit Says

News flash: Bankruptcy lawyers are human beings. Some have human emotions. Sometimes, they fall in love and marry. They may even fall in love when their firms are adversaries.

Upholding a decision by retired Bankruptcy Judge Christopher S. Sontchi of Delaware, the Third Circuit described how firms should handle romances to avoid disqualification. Basically, the circuit says to employ an elaborate screen and follow the details described in the September 9 opinion by Circuit Judge David J. Porter.

The Conflict

A large company confirmed a chapter 11 plan in 2016, creating a liquidating trust. In June 2018, the trust filed a \$14 billion lawsuit against the debtor's former parent.

The trust-plaintiff was represented by a large, international law firm with more than 2,000 lawyers. The defendant-parent was represented by several other large firms.

A partner in one of the defendant's firms left that firm and joined the plaintiff's firm as a partner in October 2020. The departing partner had billed 300 hours to the case on behalf of the defendant.

So far, nothing surprising. Moves like that take place all the time. Conflicts and disqualifications are avoided by ethical screens, and a screen is what the plaintiff's firm put in place immediately after the move.

After the partner left the defendant's firm to join the plaintiff's firm, the defendant-parent filed a motion to disqualify the plaintiff's law firm. Bankruptcy Judge Sontchi denied the motion. *Maxus Liquidating Trust v. YPF SA (In re Maxus Energy Corp.)*, 626 B.R. 249 (Bankr. D. Del. April 6, 2021). To read ABI's report, [click here](#).

Here's what makes the case different: The department head for the plaintiff was in a romantic relationship with the defendant's departing partner. The relationship turned into marriage. The department head at the plaintiff's firm never billed any time to the matter.



According to the opinion by Bankruptcy Judge Sontchi, the timeline for the relationship went like this:

The two began dating in early 2017. The lawsuit was filed in 2018. The relationship became “exclusive” in the fall of 2018, and they began living together in July 2019.

Judge Sontchi found that the partner who moved had disclosed the relationship to the firm in 2018 and believed that the relationship had been disclosed to the defendant. The lawyer with the defendant’s firm joined the plaintiff’s firm as a partner on October 1, 2020. They married in November 2020.

As previously mentioned, the plaintiff’s firm set up an ethical screen immediately after the move and notified the defendant.

After denying the motion for disqualification, Judge Sontchi authorized a direct appeal, which the Third Circuit accepted.

The Affirmance

Because the appeals court was reviewing for abuse of discretion, the affirmance by Judge Porter is sparse, compared to the meticulous opinion by Bankruptcy Judge Sontchi. Judge Porter said that “an abuse of discretion occurs ‘where no reasonable person would adopt’ the lower court’s view. *United States v. Foster*, 891 F.3d 93, 107 n.11 (3d Cir. 2018).”

Judge Porter explained that the bankruptcy court in Delaware has adopted the American Bar Association’s Model Rules of Professional Conduct as local rules. Model Rule 1.9 bars a client’s former lawyer from representing someone “materially adverse” on a “substantially related matter.” Model Rule 1.10(a) disqualifies an entire firm if one lawyer is disqualified “unless” the “disqualified lawyer is timely screened” and receives “no part” of the fee.

Summarizing the rules, Judge Porter said:

[I]f a firm adheres to the conditions subsequent by screening the disqualified attorney, allocating to him no part of the fee from the conflicted representation, and following the other procedures in Model Rule 1.10(a)(2), the disqualified attorney’s conflict cannot be imputed to the entire firm.

Despite screening the departing partner and despite the departing partner’s exclusion from fees from the engagement, the defendant argued that the plaintiff’s firm was disqualified because the department head at the plaintiff’s firm had not been barred from receiving fees from the firm’s representation of the plaintiff.



Judge Porter rejected the argument. He said that “the rule directs that only the ‘disqualified lawyer’ must be ‘apportioned no part of the fee’ from the matter at issue. Model Rules of Pro. Conduct r. 1.10(a)(2)(i). Here, that means [the departing partner], not her spouse, must not receive proceeds of fees arising from the conflicted representation.”

Judge Porter affirmed because he found no abuse of discretion in denial of the disqualification motion. He said that the firm had established “a thorough, robust ethical screen.”

The Interesting Footnote

In text on the last page of the opinion, Judge Porter said that the departing partner would receive no part of the fees from the new firm’s representation of the plaintiff. In a footnote, he said that the plaintiff’s firm did not compensate partners “based on specific case outcomes or earnings.”

Although the Model’s Rule’s comments are not incorporated into the Delaware local rules, Judge Porter said that a comment on Rule 1.10 “persuasively says” that a screened lawyer is not prohibited “from receiving a salary or partnership share established by prior independent agreement, but that lawyer may not receive compensation directly related to the matter in which the lawyer is disqualified. Model Rules of Pro. Conduct r. 1.10, cmt 8.”

The footnote appears to be *dicta* allowing screened lawyers to suffer no cut in compensation as long as the lawyer’s earnings are not “directly related” to the matter giving rise to the conflict.

Observations

Whenever two lawyers kiss, and they’re from different firms, must they run a conflict check? If a casual date doesn’t raise a potential conflict, when does a conflict arise as the relationship becomes “serious”? When should both lawyers notify their firms? Do firms really want to know whom their lawyers are dating? Are the rules different if one or both of the lawyers are married to someone else?

Respectfully, the Model Rules don’t give answers.

The Model Rules also don’t deal with potential conflicts arising from working at home, when the couple are lawyers from different firms. Must each lawyer have a computer that the other can’t use? What about overhearing phone conversations? To be safe, must the lawyers work from separate, soundproof rooms? Is there automatically a conflict if a couple, both lawyers, are in firms that are adversaries but neither is working on the matter? When must there be disclosure and screening?



Respectfully, the Model Rules don't give answers. This writer submits that the ABA should amplify the rules to deal with personal relationships and working from home. Remember, the rules were written when few women were lawyers and everyone worked in the office.

Without better rules, perfectly innocent lawyers will be in a world of hurt if a court applies the existing rules rigorously.

[The opinion is](#) *In re Maxus Energy Corp.*, 21-2496 (3d Cir. Sept. 9, 2022).



*drafting a chapter 11 plan may avoid
having a liquidating trust pay quarterly
fees to the U.S. Trustee.*

Bankruptcy Courts Disagree on Paying U.S. Trustee Fees by Liquidating Trusts

Disagreeing with the result reached by now-retired Bankruptcy Judge Christopher S. Sontchi of Delaware, Bankruptcy Judge Kevin R. Huennekens of Richmond, Va., ruled that a liquidating trust is obligated to pay fees to the U.S. Trustee System, as the successor to the chapter 11 debtor.

Comparing the two opinions suggests that an adroitly drafted chapter 11 plan may cut off the obligation for a liquidating trust to pay fees to the U.S. Trustee, without offending the January 4 opinion by Judge Huennekens.

The Opinion by Judge Sontchi

If liquidating trusts created by chapter 11 plans must pay fees to the U.S. Trustee, creditors will have diminished recoveries because the fees can be as much as \$250,000 a quarter. The somewhat differing facts in the two cases must be understood to grasp the legal issues.

We begin with Judge Sontchi's case, *In re Paragon Offshore PLC*, 629 B.R. 227 (Bankr. D. Del. June 28, 2021). To read ABI's report, [click here](#).

In the Delaware case, the confirmed chapter 11 plan created a liquidating trust, into which the debtor transferred assets, including litigation claims. At the time of the transfer, the debtor paid fees to the U.S. Trustee based on the transferred assets.

Later, the liquidating trust settled a litigation claim that had been transferred to it by the debtor. Judge Sontchi ruled that the trust was not obligated to pay fees to the U.S. Trustee when the liquidating trust distributed the litigation proceeds to creditors.

Judge Sontchi found no obligation to pay U.S. Trustee fees because the distributions to creditors were not distributions by the debtor. Furthermore, requiring a payment would amount to double-dipping because the debtor had paid the fee when the assets were transferred to the liquidating trust.

The Virginia Plan



The chapter 11 plan in Judge Huennekens' case created a liquidating trust, but the details of the plan were different. All of the debtor's assets were transferred to the trust, and the Virginia plan said that the liquidating trust was the "successor" to the debtor "for all purposes."

The plan also specifically required the liquidating trust to pay U.S. Trustee fees "until such time as . . . the court orders otherwise," the case was closed, or the case was dismissed.

The Virginia plan was confirmed in 2016. In the second quarter of 2021, the liquidating trustee obtained authority to make the first interim distribution. The U.S. Trustee claimed a \$250,000 quarterly fee based on the distribution.

The liquidating trust filed a motion for a declaration that the trust was not obligated to pay.

Judge Huennekens' Logic

The outcome turned on 28 U.S.C. § 1930(a)(6), which calculates the fee based on "disbursements." The first words in Section 1930(a) say that the "parties commencing a case under title 11 shall pay" the fees under subsection (a)(6).

Seemingly in agreement with Judge Sontchi, Judge Huennekens said that Section 1930 made the debtor the party to pay the quarterly fees. "But," he said, the plan "intervened" and "clearly requires the Liquidating Trustee to make the Contested Quarterly Payments."

Why? Because, Judge Huennekens said, the plan made the trust "the successor of the debtors . . . for all purposes." [Emphasis in original.] In other words, he said that the "Plan removed from the Debtors the unequivocal obligation that they had to pay the quarterly fees and transferred that obligation to the Liquidating Trustee. The language of the Plan is not ambiguous on this point."

Judge Huennekens said that the U.S. Trustee had insisted that the plan contain the language requiring the liquidating trust to pay fees. Based on the idea that a plan is binding on everyone, he said that the U.S. Trustee was entitled to "the benefit of the bargain."

Judge Huennekens rejected the idea that the distributions by the trust were not "distributions" within the meaning of Section 1930. The term, he said, "must include all distributions made by the Liquidating Trustee pursuant to the Plan to the Debtors' creditors on account of their allowed claims filed against the Debtors' estates."

"Otherwise," Judge Huennekens said, "quarterly fees could be virtually eliminated by the simple expedient of transferring assets from the bankruptcy estate to a post confirmation entity for subsequent payment."



Citing three decisions by bankruptcy courts in the 1990s, Judge Huennekens said that a “majority” of courts require liquidating trusts to pay U.S. Trustee fees.

Judge Huennekens ended his opinion by showing how the *Paragon* decision by Judge Sontchi was “factually distinguishable.” The Delaware plan, he said, did not transfer all of the debtor’s assets into the trust. Furthermore, the trust was not the debtor’s successor, nor did it step into the shoes of the debtor.

In addition, Judge Huennekens noted how the Delaware debtor had already paid the fee when the assets were transferred to the trust on confirmation.

Calling the trust the “successor to the Debtors for all purposes,” Judge Huennekens directed the liquidating trust to pay the contested fee.

Observations

Three points of distinction stand out between the two cases. Drafting a plan with these distinctions in mind might avoid having a liquidating trust pay U.S. Trustee fees:

1. Don’t characterize the trust as the debtor’s successor.
2. In the quarter when the trust is funded after confirmation, have the debtor pay the fee based on the assets transferred to the trust.
3. Don’t include language in the plan explicitly requiring the trust to pay the fee.

[The opinion is](#) *In re Health Diagnostic Laboratory Inc.*, 15-32919 (Bankr. E.D. Va. Jan. 4, 2023).



Counsel run the risk of being paid lower local rates in 'mega' cases filed in the Eastern District of Virginia.

The War Between National and Local Rates Continues in Eastern Virginia

In the Eastern District of Virginia, counsel in “mega” chapter 11 cases run the risk of only being paid the prevailing local rates, not “national rates,” as a consequence of two decisions by a district judge in the reorganization of Mahwah Bergen Retail Group, Inc., a retailer that operated 2,800 stores with names like Ann Taylor, LOFT and Lane Bryant.

After vacating the debtor’s plan confirmation order due to overly broad nondebtor releases, District Judge David J. Novak of Richmond, Va., remanded the case with instructions that the bankruptcy court not allow further fee applications at rates in excess of those in Richmond.

Following remand, Chief Bankruptcy Judge Frank J. Santoro of Norfolk, Va., recommended that Judge Novak grant allowances for work performed after the reversal of confirmation at rates almost as high as the “national” rates of firms representing the debtor and the official committee.

In his recommendation on fees to Judge Novak, Judge Santoro wrote a 30-page opinion amounting to a plea for the allowance of “national” rates for counsel in “mega” cases.

Judge Novak granted the fee allowances in the amounts recommended by Judge Santoro, but he said that the calculation “in future mega cases . . . must begin with the prevailing rates in the District, not a national rate suggested by Judge Santoro.”

Reading between the lines, this writer believes that Judge Santoro allowed the fees at national rates because cutting the rates in half would have been unfair to counsel who accepted and completed the difficult engagement on the belief that they would not be paid at “local” rates.

It remains to be seen whether “mega” debtors in the future will be able to attract qualified, “national” counsel to file chapter 11 petitions in the Eastern District of Virginia.

The Reversal of Confirmation

In a scorching opinion, District Judge Novak set aside confirmation of the debtor’s chapter 11 plan in January because it contained “extremely broad third-party (non-debtor) releases.” *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167, 2022 BL 328437, 2022 U.S. Dist. Lexis 167953 (E.D. Va. Jan. 13, 2022).



Judge Novak vacated the confirmation order, voided third-party releases, severed the third-party releases from the plan, and voided an exculpation clause. To read ABI's report, [click here](#).

Judge Novak directed that further proceedings be held before another bankruptcy judge. Later, Judge Santoro reassigned the case to himself as the chief judge.

On January 13, the same day that he vacated confirmation, Judge Novak entered a second order disabling the bankruptcy court from exercising core powers by entering final orders of compensation in the case. Instead, he directed that the bankruptcy court issue proposed findings of fact and conclusions of law, "with respect to further petitions for approval of attorneys' fees."

In his second order, Judge Novak ordered "that attorneys' fees approved in this case shall not be for rates exceeding the prevailing market rates in the Richmond Division of the Eastern District of Virginia."

The Subsequent Fee Allowances in Bankruptcy Court

Fortunately, setting aside confirmation did not upset the apple cart entirely. As directed by Judge Novak, the debtor modified the plan, and it was confirmed by the bankruptcy court on March 3.

After re-confirmation, counsel filed fee applications covering the period from the reversal of confirmation on January 13 to the conclusion of the case.

Local counsel for the debtor filed an application for almost \$7,700, at a blended rate of slightly under \$500 an hour. The U.S. Trustee negotiated a \$500 reduction.

"National" co-counsel for the debtor filed an application for just over \$1 million, at a blended rate of almost \$1,000. The highest-billing lawyer charged almost \$1,500 per hour. The U.S. Trustee negotiated a reduction of \$10,000.

Chief counsel for the official creditors' committee, a "national" law firm, sought about \$270,000 at a blended rate just under \$1,000. The U.S. Trustee negotiated a \$17,000 reduction.

Judge Santoro's Fee Allowances

We won't keep you in suspense. In an opinion on August 30, Judge Santoro recommended allowing fees in the amounts negotiated by the U.S. Trustee. In other words, the fees he recommended for the two "national" firms were about twice the local rate. No one objected.



Judge Santoro's 30-page recommendation explained why he believed it would not be proper to cut national counsels' fees to local rates. He began by laying out the history of Section 330(a) and how it differed from the "spirit of economy" that prevailed under the former Bankruptcy Act.

Judge Santoro explained that Section 330(a)(3)(f), as amended, now permits the court to consider "whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title." He said that the Fourth Circuit also requires consideration of the so-called *Johnson* factors.

Judge Santoro pointed out how the Fourth Circuit had said in 1994 that rates in other communities can be considered "where it is reasonable to retain attorneys from other communities." *Rum Creek Coal Sales, Inc. v. Caperton*, 31 F.3d 169, 175 (4th Cir. 1994) (citations omitted).

Around the country Judge Santoro found a "theme" in fee allowances "for out-of-market attorneys' fees[:] . . . national bankruptcy cases are different." Citing bankruptcy court decisions from California, northern New York, and Arizona, he went on to say that "limiting counsel to local-market rates in cases that are national or regional in scope would cap attorneys' fees without consideration of whether the rate is reasonable in the particular case."

Instead, Judge Santoro said that "the court must assess whether a requested rate is justified based upon the facts and circumstances of the case." He said that the "interdisciplinary nature of large Chapter 11 bankruptcy cases, together with the exigencies and sheer magnitude of work involved, typically means that local counsel is not 'truly available' to take on such cases."

With regard to the services by the two national firms, Judge Santoro referred to the "favorable outcome" they achieved and their "high level of experience, legal knowledge, and skill in the face of unique issues and significant time pressure." With regard to one firm, he found that "out-of-market rates are reasonable under the particular facts and circumstances of this case." Regarding the other, he said that "the rates reflect the firm's experience, capabilities, and position in the national market."

Given the "excellent results under challenging circumstances," Judge Santoro recommended that the district court grant the fee allowances with the small cuts negotiated by the U.S. Trustee.

Approval in District Court

In his four-page opinion on September 16, District Judge Novak recited the instruction in his January 13 order that fees may not exceed the "prevailing rate" in the district. Acknowledging that no one objected, he went on to say that the "Bankruptcy Court approved the rates requested, although they exceeded the prevailing rates" in the district.



Judge Novak adopted the report “as the opinion of the Court, subject to the modifications below.” He approved payment of the negotiated fees, “[d]ue to the unique procedural posture of the case.” He added that he “agrees with the Bankruptcy Court’s analysis that this case warrants rates exceeding the prevailing market rates in the Eastern District of Virginia.”

“In future mega cases,” Judge Novak said, “the ‘yardstick’ for the rate calculation must begin with the prevailing rates in this District, not a national rate suggested by Judge Santoro. . . . [T]he appropriate rate calculation in a mega case must be determined on a case-by-case basis with detailed findings addressing Section 330(a)(3) and the *Johnson* factors in each case.”

Pure Speculation

It’s pure speculation on the part of this writer, but it is possible that Judge Novak did not impose local rates from concern that the two “national” firms would appeal and win reversal in the Fourth Circuit. It remains to be seen whether other bankruptcy and district courts in eastern Virginia will follow Judge Novak. We may never know, because “national” firms may henceforth shy away from Virginia.

The [recommendation](#) by Judge Santoro is *Retail Group Inc.*, 20-33113 (Bankr. E.D. Va. Aug. 30, 2022); and the [opinion](#) by District Judge Novak is *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167 (E.D. Va. Sept. 13, 2022).



*Preferences, Fraudulent Transfers &
Claims*



The failure to convert a contingent interest into ownership is not a transfer that could be avoided as a fraudulent transfer.

Failure to Exercise a Purchase Option Is Not a Transfer, Third Circuit Says

The termination of an option to purchase is not a transfer that could be set aside as a fraudulent transfer, according to a *per curiam* opinion from the Third Circuit. Thomas L. Ambro was among the three circuit judges that issued the nonprecedential opinion on December 15.

The debtor confirmed a chapter 11 plan that transferred real property to a secured creditor. The plan gave the debtor an option to repurchase the property. The plan contained details on when and how the debtor could exercise the repurchase option.

Five years later, the secured creditor sent notices, required by the plan, telling the debtor that the repurchase option had to be exercised within 30 days. The debtor did not respond.

Six months later, the debtor filed another chapter 11 petition, listing the property and the purchase option as assets. The secured creditor filed a complaint seeking a declaration that the property was not part of the new chapter 11 estate. The debtor counterclaimed, contending that the termination of the repurchase option could be avoided as a fraudulent transfer under Section 548.

Bankruptcy Judge John K. Sherwood of Newark, N.J., ruled that the repurchase option had terminated before bankruptcy and that there was no transfer to set aside. The district court affirmed, but the debtor appealed to the circuit.

De novo, the circuit reviewed the question of whether the termination of the option was a transfer.

“Leaving aside the issue of fraud,” the circuit panel said that “the District Court correctly found the option to repurchase the Property to be a future contingent interest protected under the Bankruptcy Code.”

However, the panel said, the “Debtors’ failure to convert this contingent interest into actual ownership did not amount to ‘dispos[ing] of or part[ing] with’ their protected interest in the Property. *See* § 548(a)(1)(B).”



Quite simply, the panel said, the “Debtors did not transfer their option rights to [the secured creditor] but rather ‘failed to pursue a business opportunity’ by allowing their interest in potential ownership to lapse.” Therefore, “any interest in the Property no longer existed when they filed for bankruptcy.”

The panel held that “the option did not constitute a ‘transfer’ under the Bankruptcy Code’s § 548(a)(1)(B)” because the “Debtors did not possess the option they failed to pursue.”

[The opinion is](#) *Berley Associates LLC v. 62-74 Speedwell Ave. LLC (In re Pazzo Pazzo Inc.)*, 21-2344 (3d Cir. Dec. 15, 2022).



Circuit Judge Frank Easterbrook tersely held that the Supreme Court's Barnhill opinion overruled prior Seventh Circuit precedent.

Date of a Garnishment Order Doesn't Matter for Preferences, Seventh Circuit Says

Overruling the Seventh Circuit's own 1984 precedent in deference to the later-decided *Barnhill v. Johnson*, 503 U.S. 393 (1992), Circuit Judge Frank H. Easterbrook held that a judgment creditor is liable for a preference if the creditor collects on a garnishment within the 90-day preference window.

Even though the garnishment order was obtained outside of the preference period, it's still a preference, because the "transfer" occurs when the payment is made, Judge Easterbrook held in a typically concise, four-page opinion on January 9.

The creditor held a judgment and obtained a garnishment order more than 90 days before the debtor filed bankruptcy. Within the preference period, the creditor collected \$3,700 from the garnishment of the debtor's wages in Indiana.

The bankruptcy trustee sued the creditor to recover \$3,700 as a preference under Section 547. Relying on the Seventh Circuit's 1984 decision in *In re Coppie*, 728 F.2d 951 (7th Cir. 1984), the creditor moved to dismiss on the ground that the transfer occurred outside of the preference period when the garnishment order was issued.

Indeed, *Coppie* held that the definition of a "transfer" is governed by state law and that Indiana law defines a "transfer" as having taken place when a garnishment order is entered, not when money is paid.

Bound by *Coppie*, Chief Bankruptcy Judge Robert E. Grant of Fort Wayne, Ind., granted the motion to dismiss. The trustee filed an appeal and a motion for a direct appeal to the Seventh Circuit.

Citing *Barnhill*, Judge Grant granted the motion for a direct appeal and said that *Coppie* "should be revisited."

The Seventh Circuit accepted the direct appeal. The appeal was submitted on January 6, and Judge Easterbrook handed down his decision three days later, saying that "*Coppie* is indeed wrongly decided" in view of the Supreme Court's later opinion in *Barnhill*.



Barnhill involved a regular check that was issued outside of the preference period but paid within 90 days of bankruptcy. Judge Easterbrook paraphrased the Supreme Court’s 7/2 decision as holding “that federal rather than state law defines the meaning of ‘transfer’ in § 547” and “that the date of the check is irrelevant and that only payment of the check marks a ‘transfer.’”

Judge Easterbrook went on to say that the “rule that the ‘transfer’ occurs when money changes hands is as applicable to garnishment as it is to checks.” He described the majority opinion by Chief Justice William H. Rehnquist as having “identified as the date of transfer the time at which the money passes to the creditor’s control.”

Saying that “only the date of payment matters when defining a transfer under § 547,” Judge Easterbrook reversed dismissal of the complaint and remanded the case for resolution on the merits.

The opinion is *Warsco v. Creditmax Collection Agency Inc. (In re Harris)*, 22-1733 (7th Cir. Jan. 9, 2023).



In spreading the automatic stay, the bankruptcy court again employed the traditional analysis without recognition that the non-debtors are solvent.

Court Halts States' Police and Regulatory Suits against Non-Debtor Johnson & Johnson

In a follow-up to his opinion in February declining to dismiss the chapter 11 case filed by an indirect subsidiary of Johnson & Johnson, Chief Bankruptcy Judge Michael B. Kaplan of Trenton, N.J., held that the bankruptcy court has power to impose a stay on states' exercise of their police and regulatory powers, even though the continuation of the states' suits is exempt from the automatic stay under Section 362(b)(4).

Background

Just before chapter 11 one year ago, Johnson & Johnson formed two new subsidiaries. LTL Management LLC was created to be the debtor, and the other took over J&J's operating businesses. Two days later, LTL filed a chapter 11 petition in Charlotte, N.C. The bankruptcy judge in North Carolina transferred the case to New Jersey, where Judge Kaplan landed the dubious assignment.

LTL has no business operations of its own but assumed liability for all talc-related asbestos claims. J&J and the other non-debtor businesses agreed to supply the funds necessary for LTL to prosecute the reorganization and emerge from chapter 11.

The official committee representing talc claimants filed a motion to dismiss the chapter 11 case under Section 1112(b), contending that the filing was in bad faith. The U.S. Trustee supported either dismissal or appointment of a chapter 11 trustee. Judge Kaplan denied the motion on February 25. *In re LTL Management LLC*, 637 B.R. 396 (Bankr. D.N.J. Feb. 25, 2022).

Refusing to dismiss the case after a five-day trial, Judge Kaplan said that the chapter 11 filing "is unquestionably a proper purpose under the Bankruptcy Code." *Id.* at 408. He also granted a preliminary injunction barring the continuation of lawsuits against the non-debtor J&J parent and affiliates. The talc claimants appealed directly to the Third Circuit, which heard argument on September 19. To read ABI's report on the February 25 opinion, [click here](#).

The Lawsuits by New Mexico and Mississippi



Before bankruptcy, the states of New Mexico and Mississippi had sued J&J, alleging that the sale of products laced with asbestos violated state laws prohibiting unfair trade practices and false advertising. Among other relief, the states sought money damages.

The debtor filed an adversary proceeding against the two states in June, asking Judge Kaplan for injunctive relief to stop the states' lawsuits. The states opposed, contending that the suits were immune from the automatic stay as an exercise of governmental police and regulatory powers under Section 362(b)(4).

The Bankruptcy Court Has Jurisdiction

Judge Kaplan began with the debtor's contention that the automatic stay applied, but first, he dismissed the states' contention that the bankruptcy court lacked subject matter jurisdiction to issue or enforce a stay against them.

The states argued that the bankruptcy court had no subject matter jurisdiction because the bankruptcy court would have had no jurisdiction to preside over the police and regulatory enforcement actions. Judge Kaplan said that the proper focus was on the bankruptcy court's jurisdiction over the adversary proceeding, not the suits in state courts.

Judge Kaplan found jurisdiction because the adversary proceeding "unquestionably" involves the automatic stay and whether it was "appropriate" to extend the stay's protection to non-debtors. He held that the bankruptcy court had jurisdiction and that it was "core."

Just in case, Judge Kaplan went on to find "related to" jurisdiction because the outcome might affect the debtor's insurance coverage and its indemnification obligations.

The Automatic Stay

Next, Judge Kaplan examined whether it was "appropriate" to extend to the automatic stay to cover non-debtors.

Although the J&J entities named as defendants in the states' suits were not in bankruptcy, Judge Kaplan found that the suits were, "fundamentally, an attempt to liquidate and recover claims against the Debtor."

"Accepting the premise that [the] Debtor is a true defendant," Judge Kaplan ruled that the automatic stay applied to the suits under Section 362(a)(1). Likewise, he held that the suits were enjoined as an act to obtain possession or control of estate property under Section 362(a)(3), given the "shared insurance policies" that would be invaded by a judgment.

Extension of the Stay



If the stay were not automatically applicable to non-debtors, Judge Kaplan confronted the question of whether there were “unusual circumstances” to warrant an extension of the stay to protect non-debtors.

Having held in his February 25 opinion that there is an “identity of interest” between the debtor and its affiliates, Judge Kaplan concluded that an extension of the stay was proper, because the suits would divert resources and “disrupt the flow of funds.”

Judge Kaplan also found that continuation of the actions against non-debtors “would impair mediation efforts and ongoing negotiations taking place within this bankruptcy.”

The Exception for Regulatory Actions

Although he found the automatic stay to apply, Judge Kaplan focused on Section 362(b)(4) to decide whether there was “any applicable statutory exception” allowing the states to continue their suits. The section provides that the automatic stay does not apply to “the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit’s or organization’s police and regulatory power. . . .”

Judge Kaplan cited the advisory committee notes for saying that the exception should be given a “narrow construction.” The Third Circuit created two tests for the exception, “the pecuniary purpose and public policy tests.”

Because the suits were “proceedings related to public safety and welfare,” Judge Kaplan found with little hesitation that the exception to the automatic stay in Section 362(b)(4) did apply, even though the states also sought monetary damages. But, he said, the “conclusion does not end this Court’s inquiry,” he said.

Judge Kaplan found “nothing in the statute [that] prevents a court from imposing or extending the stay under § 362(a) subsequent to the filing.” Likewise, he found “nothing in the statute [that] precludes a bankruptcy court from issuing injunctive relief under § 105(a) enjoining the governmental unit’s proceedings where circumstances so warrant.”

Judge Kaplan found “that the exercise of the States’ police power seriously conflicts with the policies underlying the Bankruptcy Code.” He therefore held that “§ 362(b)(4)’s prevention of an ‘automatic’ stay upon the filing of the bankruptcy does not bar this Court from imposing or extending the stay under § 362(a), or otherwise restrict this Court’s ability to issue injunctive relief under § 105(a).”

A Section 105(a) Injunction



Judge Kaplan ended his 45-page opinion by finding justification and power for a non-debtor stay under Section 105(a) and the traditional rules for preliminary injunctions.

In that regard, he found that the debtor had a likelihood of success on the merits and had shown irreparable harm in the absence of stay. On the other hand, he saw only “minimal harm” to the states resulting from a stay.

In terms of public interest, Judge Kaplan said it would be “patently unfair to permit the States to proceed while others — particularly those who allege more direct, personal harm — must wait.”

The stay will not be open ended. Judge Kaplan said that he would “revisit continuation of the automatic stay” at a hearing in December.

[The opinion is](#) *LTL Management LLC v. State of New Mexico (In re LTL Management LLC)*, 22-01231 (Bankr. D.N.J. Oct. 4, 2022).



An Oregon power company appears headed for the Ninth Circuit to decide whether electric power qualifies as “goods” to be accorded the 20-day priority.

Electric Power Held *Not* to Be Goods with a 20-Day Priority Under Section 503(b)(9)

A public utility in Oregon seems intent on having the Ninth Circuit decide whether electric power supplied within 20 days of bankruptcy is “goods” entitled to priority under Section 503(b)(9).

The courts are divided, but District Judge Ann Aiken of Eugene, Ore., upheld Bankruptcy Judge Peter C. McKittrick by holding that electric power is not “goods” and does not give rise to a priority claim.

A public utility supplier of electricity filed a claim for some \$500,000. The claim included administrative priority under Section 503(b)(9) for more than \$200,000 in electricity provided within 20 days of bankruptcy. The debtor objected to priority status.

Bankruptcy Judge McKittrick held an evidentiary hearing at which he heard testimony from physicists from both sides. He sustained the debtor’s objection to priority status.

Judge McKittrick reasoned that electricity, traveling at the speed of light, is not movable and is therefore not goods within the definition of the Uniform Commercial Code because it will have been consumed by the device that used the electricity before the usage could be recorded by the electric meter.

The power company appealed.

The Standard of Review

The bankruptcy judge credited the testimony from the debtor’s physicist. Should District Judge Aiken review for clear error? Or does the definition of “goods” contained in Section 503(b)(9) lead to *de novo* review?

Judge Aiken accepted the approach taken by a district judge in New York who held on an identical appeal that administrative status is a question of law for review *de novo*. See *In re Great Atlantic & Pacific Tea Co., Inc.*, 538 B.R. 666 (S.D.N.Y. 2015).



The Statutes

Section 503(b)(9) affords priority to a claim for

the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

The Bankruptcy Code does not define "goods." Most courts refer to the UCC, which defines goods as

all things (including specially manufactured goods) which are *movable at the time of identification to the contract for sale* other than the money in which the price is to be paid, investment securities (Article 8) and things in action
[Emphasis added.]

Citing the Ninth Circuit Bankruptcy Appellate Panel, Judge Aiken said that priorities are to be "strictly construed" because creditors are entitled to priority "only when clearly authorized by Congress." *In re Lorber Indus. of Cal.*, 373 B.R. 663, 667-68 (B.A.P. 9th Cir. 2007).

Although courts agree on using the UCC definition, Judge Aiken said in her February 3 opinion that they reach "starkly contradictory results" when applying the definition to electricity. The debtor stood behind *Great Atlantic & Pacific* while the power company urged Judge Aiken to follow *In re Escalera*, 563 B.R. 336 (Bankr. D. Colo. 2017). To read ABI's report on *Escalera*, [click here](#).

Judge Aiken was persuaded by *Great Atlantic & Pacific*. She reasoned that

[e]lectricity is not "identified" until it has been recorded by the meter and, because of the speed that electricity moves through the wire and the comparative slowness of the meter, the electricity has been consumed by the time that identification occurs.

Holding that "electricity is not, therefore, movable at the time of identification," Judge Aiken upheld Bankruptcy Judge McKittrick's conclusion that the claim was not entitled to priority.

The opinion is *Pacificorp v. North Pacific Cannery & Packers Inc.*, 21-00863 (D. Ore. Feb. 3, 2023).



The transferee of a claim doesn't have standing to object to recording the transfer of a claim to it on the claims docket, Judge Garrity says.

Claims Agents Aren't Junior Judges Ruling on the Validity of Claim Transfers

Bankruptcy Judge James L. Garrity, Jr., of New York wrote a devilishly complex opinion standing for the proposition that a claims and noticing agent is not a junior judge acting as a gatekeeper to rule initially on the validity of the transfer of a claim.

Rather, Judge Garrity said in his September 13 opinion that a claims agent must record a transfer if the transfer was made before the proof of claim was filed. After a claim has been filed, the claims agent must record the transfer on the claims docket if there was no objection by the transferor. The transferee has no right to lodge an objection to the transfer of a claim allegedly transferred to it.

The dispute arose in the chapter 11 reorganization of a large company. With the court's authorization, the debtor engaged a claims and noticing agent. The claims agent was tasked with maintaining the claims docket and recording transfers of claims in the manner a court clerk would record claims and transfers under Bankruptcy Rule 3001.

A subsidiary of another large company held a claim for more than \$15 million. Before the subsidiary-creditor filed the claim, it sold the claim for about \$10 million to an entity that we shall refer to as Transferee I.

The next day, Transferee I sold the claim for the same price plus a \$100,000 brokerage commission to an entity that we shall refer to as Transferee II. Transferees I and II both quickly filed appropriate notices of the transfers with the claims agent.

Later, Transferee II evidently had buyer's remorse and attempted to undo the purchase of the claim on grounds we shall discuss below.

When both transfers took place, the subsidiary-creditor had not filed a proof of claim. Then, the bankruptcy court entered an order allowing the claim for \$15 million. The allowance order did not require the subsidiary-creditor to file a proof of claim.

The claims agent learned that the bankruptcy court would enter an order somehow amending the order allowing the claim. The claims agent "paused" the processing of the two transfers. The



subsequently amended order allowed the claim in the same amount but gave the subsidiary-creditor 30 days to file a proof of claim.

The subsidiary-creditor did not file a claim. With no claim on file, the claims agent did not process the transfers. Instead, it served notices of defective transfers with respect to both transfers. All of this was occurring before any proof of claim had been filed.

Months after the 30-day deadline, the subsidiary-creditor's parent filed the claim, but the parent was not the holder of the allowed claim. (Just goes to show, anything that *can* go wrong, *will* go wrong.)

The claims agent still refused to process both transfers because the parent that filed the proof of claim was not the holder of the claim allowed by court order. The claims agent said it would record the transfers if the subsidiary-plaintiff filed the claim.

Around that time, Transferee II decided it no longer wanted the claim. Pointing to the notices of defective transfers and provisions in the agreement under which it bought the claim, Transferee II demanded that the subsidiary-creditor repay the purchase price, with interest.

Aiming to clean up the mess, the subsidiary-creditor filed the proof of claim, and the parent withdrew the claim it had filed. The claims agent then sent the subsidiary-creditor and Transferee I notices of the transfer under Bankruptcy Rule 3001(e)(2). (We're getting ahead of ourselves, but note that Rule 3001(e)(2) lays out the procedure for transfers *after* a claim has been filed, but these transfers were *before* the claim was filed.)

Transferee II reacted by telling the claims agent that it did not consent to recording the transfers. The claims agent responded by reversing the processing of both transfers. Transferee II also filed a lawsuit in state court against the subsidiary-creditor, demanding return of the purchase price.

The subsidiary-creditor filed a motion asking Judge Garrity for a direction that the claims agent record the transfers. Transferee II objected to the motion, contending that the bankruptcy court had no right or jurisdiction to decide who owned the claim.

Judge Garrity said in his opinion that he was not ruling on ownership of the claim, only deciding narrow issues regarding the transfer of the claim. Rather, he said that the motion called on him to decide whether the transfer to Transferee I should be recognized on the claims docket.

Unraveling the mess, Judge Garrity began by saying that the claims agent "is acting as an agent of the Clerk of the Court under section 156(c)." He said there was "no dispute" that there had been an unconditional transfer to Transferee I and that the transfer "conformed with nonbankruptcy law and Bankruptcy Rule 3001(e)."



Judge Garrity said that the claims agent erred by refusing to record the first transfer “since [the claims agent] misapplied Bankruptcy Rule 3001(e)(1) — the rule under which the [claim] was transferred.”

Other minor errors aside, Judge Garrity said that transfers were of a claim before the filing of a proof of claim. For transfers before the filing of a claim, he cited Bankruptcy Rule 3001(e)(1) and the *Collier* treatise to say that the rule “does not mandate the filing of a proof of claim in order to fully effectuate such a transfer.” Therefore, the fact that the claim had not been filed when the transfers occurred was not grounds for the claims agent to issue the notice of defective transfer.

Judge Garrity held that the retention of the claims agent “does not authorize [the claims agent] to adjudge the validity of the transfer of claims under Bankruptcy Rule 3001(e)(1).” The claims agent therefore erred when it “paused” the processing of the first transfer because “it misapplied Bankruptcy Rule 3001(e)(2) to a claim that was transferred under Bankruptcy Rule 3001(e)(1).”

Judge Garrity had an alternative ground for his decision. Even if the claims agent properly issued the notice of defective transfer, he said that the transfer to Transferee I “should be recognized and recorded on the claims register under Bankruptcy Rule 3001(e)(2)” because the transferor [the subsidiary-creditor] did not object to the transfer.

Judge Garrity explained:

[U]nder the plain language of the statute, only the transferor has standing to object to the transfer of a filed proof of claim under Bankruptcy Rule 3001(e)(2). Third parties, like [Transferee II], do not have standing to object to a claim assignment itself.

Judge Garrity granted the motion and directed the claims agent to recognize the transfer to Transferee I and recognize Transferee I as the holder of the claim.

[The opinion is](#) *In LATAM Airlines Group S.A.*, 20-11254 (Bankr. S.D.N.Y. Sept. 13, 2022).



Judge Glenn allowed the redaction of individual crypto customers' home and email addresses, but requires the disclosure of their names and the amount of their claims. No redactions for business customers.

New York Judge Splits with Colleagues on Redaction of Crypto Customers' Names

Is there something special about a crypto company to justify the nondisclosure of the names of its creditors and customers?

Evidently not, in the opinion of Bankruptcy Judge Martin Glenn of New York. In his September 28 ruling, he only allowed the debtor to redact the home and email addresses of *individual* customers and creditors, “to protect the individuals from harassment and identity theft.”

Judge Glenn is requiring the crypto debtor to file schedules showing the creditors' names and how much they are owed, without showing individual creditors' home or email addresses. However, the debtor must show the physical and email addresses of corporate or business customers and creditors.

To ensure that redaction will not hinder securities law regulators, Judge Glenn dropped a footnote to say that he would “consider releasing unredacted information” for “good cause shown on motion of any party in interest.”

Judge Glenn conceded that his decision is at odds with a recent case in New York and two from the bankruptcy court in Delaware.

The Crypto Debtor

The debtor described itself as “one of the largest and most sophisticated cryptocurrency-based finance platforms in the world [with] clients across more than 100 countries.” In addition to holding customers' deposits of crypto assets, the debtor said that its users could “take loans using those transferred crypto assets as collateral.” The debtor claimed to have “more than 1.7 million registered users and approximately 300,000 active users with account balances greater than \$100.”

Before bankruptcy, Judge Glenn described how the debtor “froze all customer accounts, refusing to permit any withdrawals of crypto assets. That step,” he said, “has not won many fans among Debtors' customers,” as shown by “the flood of *pro se* filings on the docket.”



About two weeks after the chapter 11 filing, the debtor filed a motion to redact information in court filings regarding customers, creditors, officers and employees.

More specifically, the debtor wanted authorization from Judge Glenn to redact (1) the home and email addresses of individual U.S. citizens, including customers, creditors and the debtor's employees and shareholders; and (2) the names, home addresses and email addresses of any citizens of the U.K. or E.U. countries and anyone whose citizenship was unknown.

Later, the debtor filed a motion to expand the redactions to include all individuals' names, not just their email and physical addresses. The objective was to disassociate account balance with customers' claims.

Judge Glenn quoted the debtor's papers as saying that "retaining anonymity is one of the key features of holding crypto assets." The debtor, he said, argued that "customers, employees, directors, and officers . . . fear for their safety and their families' safety if their home addresses, email addresses, and/or names are published on the public court docket."

The official creditors' committee supported the redaction motion, but the U.S. Trustee opposed.

The Statutory Criteria

Judge Glenn began with the "strong presumption and public policy in favor of public access to court records" and comprehensively laid out the various statutes and rules that allow sealing or redaction.

The principal authority for authorizing redactions is found in Section 107(b), which allows the court to protect trade secrets "or commercial information." A debtor is not required to show good cause for redacting commercial information, which need not rise to the level of a trade secret. However, the debtor must show that disclosing the information would give "an unfair advantage" to competitors.

Under Section 107(c), the court, "for cause, may protect an individual . . . to the extent the court finds that disclosure of such information would create undue risk of identity theft or other unlawful injury to the individual." The protected information is "[a]ny means of identification." According to the *Collier* treatise, the purpose is to obviate "an undue risk of identity theft or unlawful injury to the individual or the individual's property."

The debtor argued that redacting the names of customers and creditors was necessary to prevent competitors from poaching the debtor's customers. Judge Glenn rejected the idea, saying it was not "sufficient evidence to support sealing of the *names* of all creditors." [Emphasis in original.]



“[A]t least for *individuals* who maintained accounts with the Debtors,” Judge Glenn held that the “Debtors should redact home addresses, telephone numbers and email addresses, but not the creditors’ names, from any Court filings, to protect the individuals from harassment and identity theft.” [Emphasis in original.] He went on to say that his ruling would give the debtor protection for “whatever commercial value may flow from that information.”

Judge Glenn emphasized that he was “only granting that protection with respect to addresses of individual customers, not for corporate, LLP or LLC customers.” He explained that “personally identifiable information” is defined in Section 101(41A) as covering only information provided to a debtor by “an individual.” He said “it does not include information provided by business entities.”

Once email and physical addresses for individuals are removed, Judge Glenn ruled that the names of 300,000 customers “[do] not meet the standard for confidential ‘commercial information’ under section 107(b)(1).” He reasoned that names alone would not provide “a viable means” for poaching customers, “assuming that alone would be enough to justify protection.”

To protect the debtor’s employees, officers and directors from harassment, Judge Glenn authorized the debtor to redact their home and email addresses.

In short, Judge Glenn said he was authorizing “the redaction of the home addresses and email addresses, but not the names, of the individual account holders.”

Because he did not see Section 107(c) as covering businesses, Judge Glenn refused to permit the redaction of the “names, email addresses and physical addresses to the extent the sealing requests apply to business entities and not individuals.”

The debtor wanted all information redacted regarding customers who reside in the U.K. and the E.U., because disclosure might violate regulations in those countries. Judge Glenn said he would “not treat the UK and EU citizens differently than the United States citizens implicated in this case filed in New York.”

Judge Glenn said the debtor provided “no legal authority explicitly dictating why [laws in Europe] should apply to the bankruptcy cases of the Debtors filed in the United States, or specifically, why the foreign laws would take precedence in a situation where United States law requires the disclosure of the information.”

Judge Glenn made several other rulings of moment. Applicants for professional retention must disclose the identity of those covered in their conflict checks. However, he allowed counsel to redact the identity of parties that might participate in financing.



Finally, Judge Glenn dealt with the debtor's separate motion to disassociate creditors' names from the amount of their claims. He denied the debtor's request because creditors should be able to consult the schedules to ascertain whether their claims were listed and whether they were disputed or undisputed.

[The opinion is](#) *In re Celsius Network LLC*, 22-10964 (Bankr. S.D.N.Y. Sept. 28, 2022).



One month apart, two judges in New York differed on the extent to which they permitted redactions of information about creditors, their identities and addresses.

In Mass Tort Cases, New York Judge Permits Redactions of Creditors' Names

The extent to which the names, addresses and other identifying information about creditors will be redacted in public filings seems to depend in New York upon the nature of the debtor's business and, perhaps, on the judge.

In late September, Bankruptcy Judge Martin Glenn of New York did not permit the extent of redactions requested by a so-called crypto debtor. He only allowed the debtor to redact the home and email addresses of *individual* customers and creditors, "to protect the individuals from harassment and identity theft."

Judge Glenn required the crypto debtor to file schedules showing the creditors' names and how much they are owed, without showing individual creditors' home or email addresses. However, he required the debtor to show the physical and email addresses of corporate or business customers and creditors. See *In re Celsius Network LLC*, 22-10964, 2022 BL 342784, 2022 Bankr Lexis 2672 (Bankr. S.D.N.Y. Sept. 28, 2022). To read ABI's report, [click here](#).

Judge Glenn conceded that his decision was at odds with a recent case in New York and two from the bankruptcy court in Delaware.

One month later, Bankruptcy Judge James L. Garrity, Jr., of New York ruled on a similar redaction motion by a debtor holding sensitive information about creditors, employees and shareholders. Indeed, the personally identifying information might have been more sensitive than it was in Judge Glenn's case because tort creditors in Judge Garrity's case have claims arising from the sale of opioids and transvaginal surgical mesh products.

In his November 2 opinion, Judge Garrity allowed the debtor to redact the home addresses and email addresses of individual tort claimants from any court paper. Unlike Judge Glenn, he went further by allowing the redaction of the tort creditors' names. Naturally, Judge Garrity directed the debtor to provide the official committees and the U.S. Trustee with unredacted information under strictures of confidentiality.

In the case before Judge Garrity, creditors are not yet being required to file proofs of claim. When the time comes, the debtor promised to seek authority for similar redactions. To the extent



that creditors file claims in the meantime, Judge Garrity allowed the debtor “to withhold publication of individuals’ proofs of claim.”

Judge Garrity devoted a substantial part of his 36-page opinion to explaining why broader redactions were appropriate to avoid “identity theft or stalking and intimate partner violence.” Based on statistics from the Department of Justice and the Centers for Disease Control, he said that the threats were “real, not theoretical.”

In reaching his conclusions, Judge Garrity explained the statutory and rule-based grounds for redactions. Of course, he began from the “strong presumption and public policy in favor of public access to records.” [Note from this writer: The presumption arose decades before identity theft began afflicting substantial portions of the population every year.]

While Section 107(a) codifies the common law right to public access, Judge Garrity explained how Section 107(c) provides exceptions to the general rule by allowing the court, for “cause,” to “protect an individual” from disclosure of information that “would create undue risk of identity theft or other unlawful injury to the individual or to the individual’s property.”

Similarly, Bankruptcy Rule 1007(j) allows the court to “impound[] . . . the lists filed under this rule [and to] refuse to permit inspection by any entity.” Judge Garrity cited 28 U.S.C. § 1028(d)(7) for a “non-exclusive list of personally identifiable information” that may be redacted.

We recommend reading the opinions by Judges Glenn and Garrity in full text to grasp the nuances in the redactions they permitted (or didn’t permit) and the grounds for their conclusions.

[The opinion is](#) *In re Endo International plc*, 22-22549 (Bankr. S.D.N.Y. Nov. 2, 2022).



Although a UCC lien on ‘accounts’ would attach outside of bankruptcy to proceeds from the sale of real property, Section 552(b) cuts off attachment if the sale occurs after filing.

A UCC Lien on ‘Accounts’ Won’t Attach to a Postpetition Sale of Real Property

A prepetition UCC lien on “all assets” and “accounts” does not attach to proceeds from the postpetition sale of real property, according to Bankruptcy Judge Christopher M. Lopez of Houston.

More precisely, a UCC lien on “accounts” would attach to proceeds from the sale of real property if there were no bankruptcy. However, Section 552(b)(1) prevented the lien from attaching in the case before Judge Lopez because the sale occurred after filing.

The January 24 opinion by Judge Lopez means that a UCC lien on “all assets” and “accounts” won’t be the equivalent of a mortgage on real property in bankruptcy.

Before bankruptcy, a bank had a security interest in all of the debtor’s assets and “accounts.” The bank perfected the security interest by filing the required UCC financing statement. However, the bank did not have a mortgage on real property belonging to the debtor.

In chapter 11, the court entered a so-called cash collateral order giving the bank a replacement lien and a superpriority administrative claim to the extent that the bank had a perfected security interest in cash.

After bankruptcy, the debtor obtained court approval to sell a parcel of real property that generated almost \$500,000 in net proceeds. There were no mortgages on the property.

The bank contended that its perfected lien on “accounts” included the account receivable created by the sale. The debtor agreed and sought court approval to use some \$150,000 of the proceeds to pay off the bank.

An unsecured creditor objected to paying off the bank, and Judge Lopez denied the motion.

To parse the argument, Judge Lopez first cited Section 9-102(a)(2) of the Texas Uniform Commercial Code, which defines an “account” to include “a right to payment of . . . property that



has been or is to be sold . . .” However, Section 9-109(d)(11) of the Texas UCC says that Article 9 does not apply to “the creation or transfer of an interest in or lien on real property . . .”

So, does Section 9-109(d)(11) mean that the UCC did not give rise to a lien on the account created by the sale of the real property? “No,” Judge Lopez concluded.

Citing a decision by a bankruptcy judge in New York, Judge Lopez said that the “plain language” of Section 9-102(a)(2) means that the UCC would have given rise outside of bankruptcy to a lien on an account arising from a contract to sell real property. But Section 9-102(a)(2) wasn’t the end of the story.

Section 552(a) of the Bankruptcy Code says:

Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

Judge Lopez explained that Section 552(a) “applies to after-acquired clauses providing, for example — like in this case — a blanket lien on all accounts,” whether owned or later acquired.

In the case before him, Judge Lopez said that none of the exceptions in Section 552(b) applied, because, for instance, the bank did not have a lien on inventory and the proceeds of inventory.

Since the account did not arise until after filing, Judge Lopez held that the bank’s lien did not “extend to the sale proceeds.”

The bank had another argument: The adequate-protection order gave it the proceeds from the sale.

Judge Lopez made short shrift of the argument. In one paragraph, he said there was “no evidence in the record of a diminution in the value of [the bank’s] lien on cash.” He therefore denied the debtor’s motion to pay the bank.

[The opinion is](#) *In re Burts Construction Inc.*, 22-31700 (Bankr. S.D. Tex. Jan. 24, 2023).



Sales



Anything that is 'integrally related' to a sale is moot in the Fifth Circuit, according to a New Orleans district judge.

Fifth Circuit Interprets Section 363(m) More Broadly than Other Circuits

On an issue tangentially related to a case coming before the Supreme Court in December, a district judge in New Orleans wrote an opinion pointing out how the Fifth Circuit interprets Section 363(m) more broadly than the Seventh and Ninth Circuits by mooting not only the sale of property but also the distribution of proceeds from the sale.

In chapter 11, the owner of three real properties sued the lender to challenge the validity, extent and priority of the lender's lien. The bankruptcy court granted the lender's summary judgment motion. Later, the court appointed a chapter 11 trustee.

The chapter 11 trustee and the lender entered into a settlement calling for the trustee to sell the three properties free and clear of tenants' leases and pay the proceeds to the lender, except for enough to cover the trustee's expenses.

The tenants opposed the sale motion but lost when the bankruptcy court approved the settlement and sale procedures. After the auction, the bankruptcy court approved the sale where the lender purchased one property and third parties bought the other two.

The three tenants had also filed a motion for adequate protection in the form of an assurance that they could remain in possession until 2038, when their leases would terminate. The bankruptcy court denied the tenants' motion.

The tenants appealed the sale order, but the trustee filed a motion to dismiss the appeal as moot under Section 363(m). The section provides that the "reversal or modification on appeal of an authorization . . . of a sale or lease of property does not affect the validity of a sale or lease . . . to an entity that purchased or leased such property in good faith, . . . unless such authorization and such sale or lease were stayed pending appeal."

The tenants argued that the appeal was not moot because they were only challenging the distribution of proceeds to the trustee, not the sale of the properties.

In her September 23 opinion, District Judge Sarah S. Vance outlined the different approaches among the circuits in terms of the breadth of Section 363(m). She cited a Seventh Circuit opinion by Circuit Judge Frank Easterbrook, *Trinity 83 Dev., LLC v. ColFin Midwest Funding, LLC*, 917



F.3d 599 (7th Cir. 2019), and a similar decision from the Ninth Circuit Bankruptcy Appellate Panel.

As we reported in this column, Judge Easterbrook said that Section 363(m) is a limit on remedy and not jurisdictional. He said that the section does not “prevent a bankruptcy court from deciding what shall be done with the proceeds of a sale or lease.” *Id.* at 603. To read ABI’s report, [click here](#).

On the other side of the fence, Judge Vance cited *In re Sneed Shipbuilding Inc.*, 916 F.3d 405, 410 (5th Cir. 2019), where the Fifth Circuit held that the appeal was moot because there was “no way to sever the settlement from the sale; they are mutually dependent.” To read ABI’s report, [click here](#).

Similarly, Judge Vance cited *In re Walker County Hospital Corp.*, 3 F.4th 229, 234 (5th Cir. 2021), where the Fifth Circuit held that the appeal was moot because an order amending a sale order was “integrally linked to, and indeed, inseparable from,” the sale order. To read ABI’s report, [click here](#).

Judge Vance said that the converse is also true, that “the bar of section 363(m) does not apply to the appeal of a provision that is not integrally linked to the underlying sale.”

Ruling that the appeal was moot, including the distribution of proceeds to the trustee, Judge Vance said that the “settlement agreement between [the lender] and the Trustee was entered into for the purpose of fixing the amount of [the lender’s] claim and selling the properties to satisfy that claim.”

Judge Vance went on to say that the “terms regarding distribution of sale proceeds were part and parcel of the sale — they ensured that the sale would accomplish its purpose, the satisfaction of [the lender’s] claim, while allocating to the Trustee sufficient funds to effectuate the sale and to administer the estate.”

Finding that the distribution of proceeds was “integrally linked to the underlying sale,” Judge Vance dismissed the appeal as moot.

Observations

The Supreme Court will hear argument on December 5 in *MOAC Holdings LLC v. Transform Holdco LLC*, 21-1270 (Sup. Ct.), to decide whether the failure to obtain the stay of a sale approval order erects a jurisdictional bar to appeal under Section 363(m). In other words, is Section 363(m) jurisdictional, or is it only a limitation on remedy?



This distinction is important, because a jurisdictional bar would preclude an appellate court from reviewing any aspect of a sale order.

The “jurisdictional or not” question was not before Judge Vance. Still, she interpreted Section 363(m) as broadly mooted issues related to approval from a sale order.

When the Supreme Court issues its opinion on *MOAC*, and if the Court decides that Section 363(m) is not jurisdictional, we should read the opinion carefully, looking for a hint as to whether the justices see the section as broadly or narrowly mooted issues related to the sale itself.

To read ABI’s latest report on the *MOAC* grant of *certiorari*, [click here](#).

The opinion is *In re Royal Street Bistro LLC*, 21-2285 (E.D. La. Sept. 23, 2022).



Supposedly nefarious facts aren't evidence of bad faith if they were disclosed to the bankruptcy judge who nevertheless made a finding of good faith.

A Buyer Is in Good Faith Despite Using Economic Leverage, Fifth Circuit Says

The Fifth Circuit wrote an opinion that can be cited for the proposition that a senior lender who uses economic leverage and asserts its legal rights to squeeze out a junior lender remains a good faith purchaser entitled to declare a sale moot under Section 363(m).

The April 17 opinion by Circuit Judge Patrick Higginbotham also says that facts disclosed to the bankruptcy court can't be relied on later as evidence of the senior lender's bad faith.

The developer of a hotel obtained construction financing from a secured lender. The general contractor agreed to subordinate its right to payment to the secured lender's lien.

The project ran into trouble, with the developer unable to pay more than \$14 million owing to the general contractor. The contractor filed a mechanic's lien.

Around the same time, the developer defaulted on the loan. Basically, the lender took a deed in lieu of foreclosure, putting title in the name of an affiliate of the lender. Consequently, the lender also became the owner.

The contractor sued the owner and the lender in state court, seeking a declaration that its mechanic's lien was senior to the lender's mortgage.

To recover on the defaulted loan, the lender aimed to sell the unfinished property and hired the required professionals. There being no buyer outside of bankruptcy, the lender-owner put the property into chapter 11 before Chief Bankruptcy Judge Stacey G. C. Jernigan of Dallas. The lender became the DIP lender, with the usual controls over the case.

Judge Jernigan approved sale and bidding procedures. When a stalking horse bid fell though, the lender sought permission from Judge Jernigan to buy the property for a credit bid of more than \$37 million. The credit bid was several million more than the stalking horse bid that never materialized.

The contractor objected to the allowance of the credit bid and claimed to have an "adverse claim" to the property, meaning that the lender would not be a good faith purchaser.



Judge Jernigan overruled the objections, approved the sale and declared that the lender was a good faith purchaser. The contractor appealed but failed to obtain a stay pending appeal.

The district judge dismissed the appeal as moot under Section 363(m) for lack of a stay pending appeal following a sale to a good faith purchaser. The contractor had no better success on a second appeal to the Fifth Circuit.

The Contours to an ‘Adverse Claim’

In the Fifth Circuit, the lender naturally contended that the appeal was moot under Section 363(m). The section provides that reversal or modification “of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease [to a purchaser in good faith] . . . unless such authorization and such sale or lease were stayed pending appeal.”

The contractor contended that it had an adverse claim to the property by virtue of the dispute over the priority of its mechanic’s lien. Knowledge of the adverse claim, the contractor argued, meant that the lender was not in good faith.

The outcome of the appeal turned on the Fifth Circuit’s interpretation of Section 363(m) in *In re TMT Procurement Corp.*, 764 F.3d 512, 520 (5th Cir. 2014). There, the appeals court said that knowledge of an objection to a transaction is not bad faith in itself. Judge Higginbotham quoted *TMT* for the idea that an adverse claim requires more than an objection to a transaction.

In *TMT*, the appeals court set aside a sale because the lender was not in good faith since it had knowledge about a third party’s claim of ownership. Judge Higginbotham also cited the Ninth Circuit Bankruptcy Appellate Panel for reversing a sale order when the title to the property was in dispute.

Summing up, Judge Higginbotham held “that, under the notice-definition of a good faith purchaser, the threshold for an ‘adverse claim’ is a dispute in ownership interest.” He said that the contractor had not contested ownership, only asserted a mechanic’s lien. Therefore, the contractor was not asserting an adverse claim to set aside the finding of good faith.

Other Considerations About Good Faith

Attempting to undercut the finding of good faith, the contractor argued that its lawsuit regarding priority of liens was an adverse claim. Judge Higginbotham disagreed, saying that the lien did not confer ownership rights and did not undercut the lender’s status as a good faith purchaser.



Next, the contractor argued that numerous actions by the lender-owner amounted to misconduct or fraud. For example, the contractor pointed to how the lender obtained ownership to control the bankruptcy and take over the property.

Judge Higginbotham said that becoming both the lender and owner “is not nefarious *per se*.” Instead, he said that it “reflects a market actor responding to market forces and exercising its contractual rights.”

As to myriad other facts, Judge Higginbotham said that “the lender disclosed each . . . to the bankruptcy court.” Disclosure, he said, “strongly favors a finding of good faith, as courts properly look to the transparency of the process as indicative of one’s intent.”

Holding that the “lender did not engage in fraud and was a ‘good faith purchaser,’” Judge Higginbotham affirmed the district court’s judgment dismissing the appeal as moot.

[The opinion is](#) *SR Construction Inc. v. Hall Palm Springs LLC (In re RE Palm Springs II LLC)*, 21-11244 (5th Cir. April 17, 2023).



Small Biz. Reorg. Act



Disputing the Fourth Circuit line by line and raising the possibility of a circuit split, the BAP and six bankruptcy courts have held that there's no such thing as nondischargeability for corporate Sub V debtors.

Ninth Cir. BAP Holds that Debts of Corporate Sub V Debtors Can't Be Nondischargeable

All six bankruptcy courts to confront the question have held that debts of corporate debtors in Subchapter V of chapter 11 cannot be nondischargeable under Section 523(a) in nonconsensual plans.

The Ninth Circuit Bankruptcy Appellate Panel has joined the horde by affirming Bankruptcy Judge Noah G. Hillen of Boise, Idaho, in holding that debts can be nondischargeable in Subchapter V only when the debtor is an individual.

The bankruptcy judges and the BAP are aligned against the Fourth Circuit, which held that corporate debtors in Subchapter V may not discharge debts “of the kind” specified in Section 523(a). *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI’s report, [click here](#).

Bankruptcy Judge Craig A. Gargotta of San Antonio disagreed with *Cleary* and held that “corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions.” *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337, 344 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI’s report on *GFS*, [click here](#). The Fifth Circuit accepted a direct appeal in *GFS* in April. Briefing should be completed before September.

The Facts in the BAP

The July 6 BAP opinion by Bankruptcy Judge Scott H. Gan reads like an *amicus* brief submitted in the Fifth Circuit in support of the debtor. Judge Gan refutes the Fourth Circuit’s arguments, line by line, and concludes that dischargeability should be the same whether a corporate debtor is in “regular” chapter 11 or in Subchapter V.

The facts in the BAP case pull on the heartstrings in favor of nondischargeability, but the BAP resisted the urge to make bad law in a hard case.



The debtor allegedly suffered sexual harassment and discrimination at the hands of her corporate employer. She filed a complaint with the state employment commission and was awarded the right to sue after her former employer filed a chapter 11 petition and elected to proceed under Subchapter V.

The employee filed a claim accompanied by an adversary proceeding to declare the debt nondischargeable under Section 523(a)(6) as a willful and malicious injury. Judge Hillen dismissed the complaint for failure to state a claim.

Judge Hillen relied on his own previous decision in *Catt v. Rtech Fabrications, LLC (In re Rtech Fabrications, LLC)*, 635 B.R. 559 (Bankr. D. Idaho 2021), and on Judge Gargotta's *GFS* opinion. He was not persuaded by *Cleary*, nor was Judge Gan when the creditor appealed to the BAP.

The statutes are less than clear. Section 523(a) says, "A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge an *individual debtor* from any debt for money obtained by false pretenses or fraud." [Emphasis added.]

Governing discharge for Subchapter V debtors, Section 1192 states that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A)." Subsection (2) of Section 1192 goes on to say that a discharge in Subchapter V does not cover "any debt . . . of the kind specified in section 523(a) of this title."

Finally, Section 1141(d)(1)(A) says that a "discharge under this chapter [11] does not discharge a debtor who is an *individual* from any debt excepted from discharge under section 523 of this title." [Emphasis added.]

Judge Gan said that Sections 523(a) and 1192 are "[f]acially" in "conflict." The "better interpretation," he said, "is that § 1192 reiterates § 523(a)'s application to debtors under subchapter V, and § 523(a) limits its applicability to individuals." Among other things, he said that "nothing in § 1192 obviates the express limitation in the preamble of § 523(a) or otherwise expands its scope to corporate debtors."

Noting that Congress amended Section 523(a) to add Section 1192 to the list of provisions to which it applies, Judge Gan said that accepting the Fourth Circuit's reasoning would render the amendment surplusage.

Judge Gan differed with the Fourth Circuit's idea that Section 1192, the more specific section, should control. He said that the canon of interpretation only governs when the statutes are irreconcilable, which they were not, in his view. And if they were irreconcilable, he saw Section 523(a) as being more specific, given that it applies in chapter 11 cases.



From a broader perspective, Judge Gan said that Subchapter V is part of chapter 11, “and its discharge provisions should be interpreted consistent with the overall statutory scheme in chapter 11.” He noted that Congress had narrowed the corporate discharge only once, in the amendment adding Section 1141(d), and only after eight years of deliberation.

Judge Gan said it was “improbable” that Congress would have enacted such a major change in dischargeability in a bill that was introduced and adopted within one month in 2019.

Judge Gan differed with the Fourth Circuit’s reliance on notions of fairness and equity to justify making debts nondischargeable in Subchapter V. Although the fairness idea was “plausible,” he said it did not “comport with the purpose of facilitating reorganization of small businesses.” Moreover, he said that making debts nondischargeable “is more likely to harm most general unsecured creditors by steering small businesses with nondischargeable debts toward liquidation.”

In sum, Judge Gan saw the policy considerations in *Cleary* as “unavailing.” He held “that § 1192 does not make debts specified in § 523(a) applicable to corporate debtors in subchapter V.”

[The opinion is](#) *Lafferty v. Off-Spec Solutions LLC (In re Off-Spec Solutions LLC)*, 23-1020 (B.A.P. 9th Cir. July 6, 2023).



The Fourth Circuit had recently held that both individuals and corporations in subchapter V of chapter 11 are barred from discharging debts that are nondischargeable under Section 523(a).

Judge Gargotta Splits with the Fourth Circuit on Nondischargeability in Subchapter V

To justify holding that “corporate debtors electing to proceed under Subchapter V of Chapter 11 are not subject to complaints to determine dischargeability pursuant to § 523(a),” Bankruptcy Judge Craig A. Gargotta of San Antonio issued a 25-page, line-by-line refutation of the recent, contrary holding by the Fourth Circuit in *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022).

Resolving what it called a “close” question, the Fourth Circuit held in June that “fairness and equity” required making the debts nondischargeable for a corporation, since a small business debtor in Subchapter V has an easier road to confirmation given the absence of the absolute priority rule. To read ABI’s report on *Cleary*, [click here](#).

Judge Gargotta’s Facts

Judge Gargotta’s debtor was a corporation in Subchapter V of chapter 11. A secured lender filed a complaint contending that its claims were nondischargeable under Sections 523(a)(2)(A), 523(a)(2)(B), 1141(d) and 1192.

The lender’s complaint alleged that the debtor made a misrepresentation by not disclosing that bankruptcy was imminent. The complaint also asserted that the debtor failed to disclose that the debtor had other, more senior lenders.

The debtor responded with a motion to dismiss for failure to state a claim under Rule 12(b)(6), based on the idea that corporations in Subchapter V of chapter 11 are allowed to discharge debts that would be nondischargeable by individual debtors in Subchapter V. The debtor won dismissal of the complaint in Judge Gargotta’s November 10 opinion.

The Statutory Language

The question before Judge Gargotta came down to this: Is Section 523(a) applicable to corporate debtors in Subchapter V?



Of pertinence to the case at hand, Section 523(a) says, “A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge an *individual debtor* from any debt” for money obtained by false pretenses or fraud.” [Emphasis added.]

Governing discharge for Subchapter V debtors, Section 1192 states that “the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A).” Subsection (2) of Section 1192 goes on to say that a discharge in Subchapter V does not cover “any debt . . . of the kind specified in section 523(a) of this title.”

Finally, Section 1141(d)(1)(A) says that a “discharge under this chapter [11] does not discharge a debtor who is an *individual* from any debt excepted from discharge under section 523 of this title.” [Emphasis added.]

Judge Gargotta summarized the interplay among the sections as follows:

[T]he language of § 1192(2) does not intend to except from discharge any debts that § 523(a) does not already except. Because § 523(a) unequivocally applies only to individuals, the language of § 1192(2) does not empower § 523(a) to cast a wider net than the text of § 523(a) permits. Had Congress included a phrase in § 1192(2) explicitly stating that the list found in § 523(a) applies to all debtors proceeding in Subchapter V, then the interpretation would be straightforward. Congress’s choice not to insert this language is instructive.

In drafting Section 1192, Judge Gargotta said that Congress knew how to distinguish dischargeability based on the nature of the debtor but “did not make this distinction in § 1192(2).”

Judge Gargotta said that “interpreting § 523 as excepting from discharge debts of corporate debtors in Subchapter V would be to ignore the import of § 1192 into § 523(a).” He went on to say that “corporate debtors proceeding under Chapter 11 historically have been immune to dischargeability actions under § 523(a).” He added, “For Congress to suddenly depart from this well-established principle when it enacted Subchapter V defies reason.”

Adding “§ 1192 into § 523 demonstrates that Congress intended § 1192(2) to limit the § 523 exceptions in Subchapter V to individuals only,” Judge Gargotta said. “This conclusion is mandated by the canon of statutory construction against surplusage.”

“In sum,” Judge Gargotta said, “the statutory language along with the broader Chapter 11 statutory scheme mandate this Court’s holding that corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions.”

JRB Distinguished



The lender threw *New Venture Partnership v. JRB Consolidated, Inc. (In re JRB Consolidated, Inc.)*, 188 B.R. 373, 374 (Bankr. W.D. Tex. 1995), into Judge Gargotta’s face.

In *JRB*, a different bankruptcy judge in the same district had held in 1995 that similar language in Chapter 12 made debts nondischargeable as to corporate debtors, not only individual debtors. *JRB* had been cited approvingly by the Fourth Circuit in *Cleary*.

Judge Gargotta said that Chapter 12’s incorporation of Section 523 is “broader.” He also noted that unlike chapter 12 cases, “Subchapter V is not its own chapter of bankruptcy, but rather is a subchapter of Chapter 11.”

Cleary and Other Cases

The case before him was an issue of first impression in the Fifth Circuit, Judge Gargotta said. He cited four bankruptcy courts that confronted the same question, and all held that corporate debtors in Subchapter V cannot be saddled with nondischargeable debts.

However, one of the four cases was reversed by the Fourth Circuit in *Cleary*. So, Judge Gargotta set about rebutting the six arguments on which the Fourth Circuit primarily relied. He saw *Cleary* as “frustrat[ing] the entire Chapter 11 statutory scheme.”

Dismissing the lender’s nondischargeability complaint, Judge Gargotta said that he “disagrees” with *Cleary* “and joins [his] sister bankruptcy courts in holding that corporate Subchapter V debtors should not be subject to § 523 dischargeability actions.”

For debtor’s counsel facing the same issue, Judge Gargotta has written the brief for you.

[The opinion is](#) *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 22-05052 (Bankr. W.D. Tex. Nov. 10, 2022).



Contrary to the Fourth Circuit, five bankruptcy courts have now held there's no such thing as nondischargeability for corporate Sub V debtors. The question is now before the Fifth Circuit.

Another Court Holds that Debts of Corporate Sub V Debtors Can't Be Nondischargeable

Five bankruptcy courts have now held that debts of corporate debtors in Subchapter V of chapter 11 cannot be nondischargeable under Section 523(a).

On the other side of the fence, the Fourth Circuit has held that corporate debtors in Subchapter V may not discharge debts “of the kind” specified in Section 523(a). *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI's report, [click here](#).

Bankruptcy Judge Craig A. Gargotta of San Antonio disagreed with *Cleary* and held that “corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions.” *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337, 344 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI's report on *GFS*, [click here](#). The Fifth Circuit recently accepted a direct appeal in *GFS*.

The Corporate Debtor's Motion to Dismiss

Affiliated corporate debtors filed petitions under Subsection V of chapter 11. Having litigated against the debtors before bankruptcy, a creditor lodged a complaint against the debtors contending that a \$3 million debt was nondischargeable under Section 523(a). The debtors filed a motion to dismiss for failure to state a claim.

To resolve the motion to dismiss, Bankruptcy Judge Jason A. Burgess of Jacksonville, Fla., was faced with deciding whether Section 523(a) is applicable to corporate debtors in Subchapter V.

The statutes aren't clear. Section 523(a) says, “A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge an *individual debtor* from any debt” for money obtained by false pretenses or fraud.” [Emphasis added.]

Governing discharge for Subchapter V debtors, Section 1192 states that “the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A).” Subsection (2) of Section



1192 goes on to say that a discharge in Subchapter V does not cover “any debt . . . of the kind specified in section 523(a) of this title.”

Finally, Section 1141(d)(1)(A) says that a “discharge under this chapter [11] does not discharge a debtor who is an *individual* from any debt excepted from discharge under section 523 of this title.” [Emphasis added.]

The Analysis by Judge Burgess

In his opinion on April 13, Judge Burgess said that the law “is still evolving,” but he agreed with the bankruptcy courts by holding that “exceptions to discharge under § 523(a) do not apply to corporate debtors receiving a discharge under § 1192.”

Judge Burgess cited the five bankruptcy courts holding that there’s no such thing as nondischargeability for a small business debtor in Subchapter V. *See, e.g., Gaske v. Satellite Rests. Inc. (In re Satellite Rests. Inc.)*, 626 B.R. 871 (Bankr. D. Md. 2021). To read ABI’s report on *Gaske*, [click here](#).

Although he said that the Fourth Circuit’s opinion was “well-written,” Judge Burgess devoted most of his opinion to exposing flaws in the appeals court’s logic and statutory interpretation.

Judge Burgess said he disagreed with the Fourth Circuit “primarily because” the Small Business Reorganization Act “amended the language of § 523(a) to add a reference to § 1192. If Congress intended for § 523(a) exceptions to apply to corporations receiving a discharge under § 1192, then this addition was unnecessary.”

Judge Burgess went on to say that the Fourth Circuit’s logic “would render that addition superfluous and violate a canon of statutory construction.”

As Judge Burgess reads *Cleary*, he said that the Fourth Circuit “equates debts ‘of the kind specified in section 523(a)’ to debts under § 523(a)(1)-(19), thus disregarding the introductory language of § 523(a) that limits those discharge exceptions to individuals.”

“If Congress had intended this interpretation for § 1192,” Judge Burgess said, “it could have straightforwardly referred to paragraphs (1)-(19) of § 523(a), much like § 1141(d)(6)(A) refers to specific subsections, instead of only referring to § 523(a).”

Judge Burgess held that “Subchapter V corporate debtors that receive a discharge under § 1192 are not subject to § 523(a).”

[The opinion](#) is *Nutrien AG Solutions Inc. v. Hall (In re Hall)*, 22-01326 (Bankr. M.D. Fla. April 13, 2023).



Future liability on a lease was counted as a liquidated, noncontingent debt in calculating whether the Subchapter V debtor had more than \$7.5 million in debt.

All Future Liability on a Lease Counted for Subchapter V Eligibility

If followed by other courts, a decision by Bankruptcy Judge Klinette H. Kindred of Alexandria, Va., could knock some debtors out of Subchapter V solely as result of liability on long-term leases.

In her June 14 decision, Judge Kindred distinguished a decision by Bankruptcy Judge Thomas J. Catliota of Greenbelt, Md., who held that the contingent liability on a lease is not counted in deciding whether the debtor has more than \$7.5 million in debt. *See In re Parking Mgmt.*, 620 B.R. 544 (Bankr. D. Md. 2020).

The debtor was a software developer who ran into bad times during the pandemic. With employees working from home, the debtor needed less office space. On filing in chapter 11 and electing treatment under Subchapter V, the debtor filed a motion to reject the office lease.

The rent owing throughout the remainder of the term of the lease was \$14.4 million. The landlord moved to dismiss the case as a bad faith filing. Short of dismissal, the landlord wanted Judge Kindred to declare that the debtor was ineligible for Subchapter V, counting the remaining rent under the lease.

The debtor countered by saying that future rent was contingent on the filing date and that the lease claim shouldn't be more than the capped rejection claim under Section 502(b)(6).

For Subchapter V eligibility, the outcome was controlled by Section 1182(1). It requires the debtor to have:

noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition. . . in an amount not more than \$7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

Judge Kindred said that the parties found no cases "directly on point." *Parking Management* was the closest. There, the debtor moved to reject leases alongside the filing of the petition. Evidently, lease-rejection damages would make the debtor ineligible for Subchapter V.



Because rejection was dependent on action by the court after filing, Judge Catliota held that the rejection claims were contingent and thus not included in the eligibility calculation.

Judge Kindred distinguished *Parking Management* for having only focused on rejection damages that were contingent. She said, “that does not mean this Court will ignore the Debtor’s existing pre-petition liability under the Leases in favor of post-petition events when determining eligibility.” Absent rejection, she said that the debtor would owe \$14.4 million under the lease.

“In this case,” Judge Kindred said, liability on the lease arose before filing when the lease was executed. Therefore, she held that liability on the lease “must be considered noncontingent and liquidated,” making the debtor ineligible for Subchapter V. She also rejected the idea of counting only the capped lease claim.

Believing that other creditors would not benefit from dismissal, Judge Kindred revoked Subchapter V eligibility but allowed the debtor to continue under “regular” chapter 11.

Together with granting the debtor’s motion to reject the lease, Judge Kindred also denied the landlord’s motion to dismiss for a bad faith filing. She held that the landlord had not shown both subjective bad faith and objective futility, as required by the Fourth Circuit in *Carolin Corp. v. Miller*, 886 F.2d 693 (4th Cir. 1989).

On subjective bad faith, Judge Kindred found nothing wrong with a debtor who files bankruptcy to reject a lease and cap damages. On objective futility, she said that the debtor’s 100% plan may require “some tweaks” but “cannot find that the restructuring in this case is objectively futile.”

Questions

On signing a lease, is the lessee immediately liable under state law for all of the rent during the term of the lease? Or, is the lessee only liable each month for that month’s rent when the rent comes due?

If a debtor is current on a lease on filing a Subchapter V petition, is there any debt to count with regard to the \$7.5 million cap for eligibility?

Is the debtor liable under state law for all remaining rent if the debtor was in default on filing? Or, is the debtor liable only for the amount in arrears?

If the debtor moves to assume and cure lease defaults, how much is there in lease liability? If the debtor moves to reject a lease, is Subchapter V liability based on the capped rent claim?

[The opinion is](#) *In re Macedon Consulting Inc.*, 23-10300 (Bankr. E.D. Va. June 14, 2023).



Courts are split on whether the debt providing eligibility for Sub V must have arisen from a business that was active on the filing date.

Eligibility for Subchapter V Is Liberal, but Not Wide Open

An opinion by Bankruptcy Judge Robert E. Littlefield, Jr. of Albany, N.Y., is a mixed bag for individuals aiming to qualify for reorganization under Subchapter V of chapter 11.

Fending off a lawsuit arising from a defunct business supplies one element of eligibility for Subchapter V, but Judge Littlefield's June 2 opinion also requires the debtor to show that half of total debt must have arisen from the particular business relied upon for eligibility.

The individual debtor filed a chapter 11 petition and elected treatment under Subchapter V. She owned or had owned two businesses. The debtor had no debt arising from one of the businesses that was evidently still in existence, but she had almost \$700,000 in debt arising from a business that was no longer operating.

Specifically, the debtor had been the owner of a business that defaulted on a lease. The debtor was being sued on her personal guarantee of the lease. The landlord filed a claim for about \$700,000 on the guarantee.

Total debt was almost \$1 million, so everyone agreed that 50% or more of her debt had arisen from one of the businesses, satisfying one of the criteria for Subchapter V.

The landlord objected to the debtor's eligibility for Subchapter V, contending that the debtor was not engaged in business at the time of filing. The Subchapter V trustee supported the debtor's eligibility.

The outcome turned on the definition of a Subchapter V debtor. Pertinent to the case before Judge Littlefield, Section 1182 requires the debtor to have:

noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date . . . in an amount not more than \$7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

Currently Engaged in Business or Not?



Judge Littlefield first confronted the question of whether the debtor must have been engaged in “commercial or business activities” as of the filing date. He said that a majority of bankruptcy courts found “a temporal restraint and require the eligibility analysis to review the debtor’s activity as of the petition date.” He cited, among others, *Nat’l Loan Invs., L.P. v. Rickerson (In re Rickerson)*, 636 B.R. 416, 424-25 (Bankr. W.D. Pa. 2021); and *In re Offer Space LLC*, 629 B.R. 299, 305-06 (Bankr. D. Utah 2021). To read ABI’s reports, [click here](#) and [here](#).

Judge Littlefield therefore held “that the Debtor must demonstrate she was presently engaged in commercial or business activities as of the Petition Date.”

Next, Judge Littlefield examined the “totality of the circumstances” to understand whether the debtor was engaged in business on the filing date. He said that “most courts” interpret the statute broadly “to provide wide availability for debtors to elect to file under subchapter V,” citing *In re Ikalowych*, 629 B.R. 267, 276-77 (Bankr. D. Colo. 2021). To read ABI’s report, [click here](#).

Citing *In re Port Arthur Steam Energy, L.P.*, 629 B.R. 233, 237 (Bankr. S.D. Tex. 2021), Judge Littlefield held that a “debtor can qualify for subchapter V absent the company’s traditional business operations where the company is winding down.” To read ABI’s report, [click here](#).

Applying the law to the facts, Judge Littlefield said that the debtor was defending a lawsuit on her personal guarantee of the commercial lease. He held that defense of the suit on the “personal guaranty . . . is sufficient winding down activity for the Debtor to satisfy the ‘engaged in commercial or business activities’ requirement of § 1182(1)(A).”

Nexus Between the Business and the Debt

Judge Littlefield turned to a question on which courts are split: Is it sufficient if 50% of the debt arose from all of the debtor’s businesses, or must more than 50% have arisen from the specific business making the debtor eligible for Subchapter V?

Once again citing *Ikalowych* and calling it the “seminal case,” Judge Littlefield held that 50% or more of the debt must have arisen from the business that qualifies the debtor for Subchapter V.

In the case before him, the debtor had \$700,000 in debt from her guarantee of the personal debt from the business that made her eligible for Subchapter V. He allowed the debtor to proceed in Subchapter V.

[The opinion is](#) *In re Hillman*, 22-10175 (Bankr. N.D.N.Y. June 2, 2023).



In the Alex Jones corporate Subchapter V case, Bankruptcy Judge Christopher Lopez said that the later chapter 11 filing by Jones himself, with about \$1.5 billion in debt, didn't kick the corporate debtor out of Subchapter V and into 'ordinary' chapter 11.

Later Developments Don't Undo Subchapter V Eligibility, Houston Judge Says

Writing in a high-profile case, Bankruptcy Judge Christopher Lopez of Houston wrote an opinion of nationwide significance regarding eligibility to be a debtor under Subchapter V of chapter 11. Recently enacted, Subchapter V was designed by Congress to simplify reorganization for small companies with less than \$7.5 million in debt.

In his March 31 opinion, Judge Lopez said that a debtor's eligibility for Subchapter V is determined as of the filing date. He ruled that the debtor can't be kicked out of Subchapter V if an affiliate with too much debt for Subchapter V later files a petition under "ordinary" chapter 11.

If adopted broadly, the opinion means that a family of companies with too much collective debt for Subchapter V may first put one member with less than \$7.5 million into Subchapter V and later put other companies into ordinary chapter 11 if there's too much debt. The first-filing company could thereby enjoy a simplified route to plan confirmation, while the other members of the group would face the rigors of "ordinary" chapter 11.

The Alex Jones Filings

Radio host Alex Jones gained notoriety for stating on his show that the Sandy Hook school massacre was a hoax. Families of murdered students filed defamation suits in state courts in Connecticut and Texas against Jones and his companies. The defendants defaulted, and default judgments were entered.

Jones owned one of the defendants, Free Speech Systems LLC. It filed a Subchapter V petition in July 2022, before the trial on damages concluded in Connecticut and before the damages trial began in Texas, Judge Lopez said.

Early in the Subchapter V case, Judge Lopez modified the automatic stay to allow the suits to proceed. In October 2022, a Connecticut jury awarded about \$1.4 billion. The Texas suit resulted in a judgment of about \$50 million.



In December 2022, Jones himself filed a petition under “ordinary” chapter 11 because the judgment gave him more than the \$7.5 million cap for Subchapter V.

The Plaintiffs’ Motion to Dedeignate

In February 2023, the plaintiffs filed a motion to revoke the corporate debtor’s Subchapter V status. Rather than dismiss or convert to chapter 7, the plaintiffs wanted the corporate case to continue in “ordinary” chapter 11.

The plaintiffs conceded that the corporate debtor had less than \$7.5 million in debt and was eligible for Subchapter V when it filed the original petition, but they contended that the corporate debtor lost eligibility for Subchapter V when Jones filed his own chapter 11 petition. They relied on the eligibility requirements for Subchapter V contained in Section 1182(1)(A) and (1)(B)(i).

On “the date of the order for relief,” Subsection (1)(A) provides that the debtor may have “not more than \$7,500,000” in “aggregate noncontingent liquidated secured and unsecured debts.”

Subsection (1)(B)(i) deals with filings by affiliates. It bars a debtor from Subchapter V if it is a “member of a group of affiliated [debtors](#) under this title that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$7,500,000.”

Judge Lopez said that “a debtor must satisfy both prongs *on the petition date*” and that “[s]ubparagraphs A and B must be construed together *at the same time, all the time.*” [Emphasis added.

Judge Lopez found support for his conclusion in Bankruptcy Rule 1020(a), which says that a case proceeds in accordance with the debtor’s election “unless and until” the court rules that the debtor’s election was “incorrect.”

Rule 1020(b) has a challenge period. It provides that an objection to the election must be made “no later than 30 days after the conclusion of the meeting of creditors held under § 341(a) of the Code, or within 30 days after any amendment to the statement, whichever is later.”

The plaintiff’s motion was therefore untimely. Even if it had been filed on time, Judge Lopez said he would have denied “the relief requested . . . for the reasons stated above.”

Judge Lopez found “practical” reasons for a more static view of Subchapter V eligibility. If eligibility were governed by events after filing, “debtors could float in and out of Subchapter V at any time,” he said.



“A roaming eligibility trap,” Judge Lopez said, “could also punish an innocent Subchapter V debtor.” One member of a corporate group, with its own board, could file a petition under Subchapter V, to be undone by a subsequent filing by another member of the group with a different board, “perhaps with unrelated debts.”

Judge Lopez denied the motion to revoke the corporate debtor’s Subchapter V election. However, he ended the opinion by noting that the debtor is not out of the woods. He said there are “several” nondischargeability adversary proceedings.

With regard to nondischargeability as to corporate debtors, courts disagree. The Fourth Circuit ruled that corporate debtors in Subchapter V may not discharge debts “of the kind” specified in Section 523(a). *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI’s report, [click here](#).

Bankruptcy Judge Craig A. Gargotta of San Antonio disagreed with *Cleary* and held that “corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions.” *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337, 344 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI’s report, [click here](#).

A direct appeal in *GFS* is pending in the Fifth Circuit.

The outcome of the Fifth Circuit appeal in *GFS* may determine whether Free Speech Systems can discharge debts to the Connecticut and Texas debtors. If the Fifth Circuit agrees with the Fourth Circuit, the judgments may not be dischargeable.

[The opinion is](#) *In re Free Speech Systems LLC*, 22-60043 (Bankr. S.D. Tex. March 31, 2023).



*The \$7.5 million debt cap for
Subchapter V doesn't include the debt of
affiliates who file later.*

Bankruptcy Judges Agree: Later Developments Don't Undo Subchapter V Eligibility

Bankruptcy judges in Virginia and Texas agree: Subsequent events do not unravel eligibility for Subchapter V.

Specifically, Bankruptcy Judge Rebecca B. Connelly of Harrisonburg, Va., held that a debtor's eligibility for Subchapter V is determined as of the filing date. Even if an affiliate files bankruptcy the next day with more debt than Subchapter V permits, the first debtor to file remains eligible to reorganize under Subchapter V.

A husband and wife filed a chapter 11 petition and elected to proceed under Subchapter V. The husband was the sole owner and manager of a corporation. The next day, the corporation filed a chapter 7 petition.

The U.S. Trustee agreed that the husband and wife, standing alone, were eligible for Subchapter V because their combined debt did not exceed \$7.5 million. However, the couple and the corporation were affiliates under Section 101(2). If the corporate debt were added to the individuals' debt, the combined debt would exceed \$7.5 million, making the couple ineligible for Subchapter V.

If it matters, the couple first consulted an attorney regarding a bankruptcy filing by the corporation. Evidently, counsel advised the couple that they should file first under Subchapter V, because a prior filing by the corporation would relegate them to "ordinary" chapter 11.

The U.S. Trustee filed a motion aimed at forcing the individual debtors to proceed under "ordinary" chapter 11 because their debt, when combined with the corporation's, exceeded \$7.5 million. Judge Connelly denied the motion in her May 17 opinion.

The U.S. Trustee admitted that the couple by themselves were eligible for Subchapter V under Section 1182(1)(A) because they were engaged in commercial activity and had not more than \$7.5 million in debt "as of the date of the filing of the petition," of which not less than 50% arose from commercial activity.

The sticking point, according to the U.S. Trustee, was Section 1182(1)(B)(i). It bars a debtor from Subchapter V if it is a "member of a group of affiliated [debtors](#) under this title that has



aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$7,500,000.”

The U.S. Trustee argued that the court must consider eligibility based on events that occur postpetition, because the words “as of the date of the filing of the petition” appear in subsection (1)(A) but not in subsection (1)(B).

Judge Connelly disagreed. She said that the “language of section 1182 does not direct a court to determine petition eligibility based on postpetition events.” More specifically, she said:

Section 1182 does not say the conditions are ongoing, include postpetition events, or persist “throughout the case,” nor does section 1182 contain any other language to provide that the debtor’s eligibility is not determined as of the initiation of the case under subchapter V.

The U.S. Trustee contended that a recent amendment adding the words “under this title” to Section 1182(1)(B)(i) means that eligibility is a continuing qualification. Again, Judge Connelly disagreed. She said it was added to make the statute

abundantly clear that the term “debtors” in section 1182(1)(B)(i) is not limited to a group of affiliated debtors which are all proceeding under subchapter V — it was made clear that the debt of any affiliate debtor under any chapter be counted in the calculation.

Judge Connelly rejected the idea that the debtors filed in bad faith because they put themselves into bankruptcy just one day before the affiliated corporation. She said that “the U.S. Trustee has failed to show how professional advice and deliberate planning of the timing of a bankruptcy petition is unlawful or abusive.”

On the merits, Judge Connelly said she agreed with Bankruptcy Judge Christopher Lopez of Houston and his decision in *In re Free Speech Sys., LLC*, 649 B.R. 729, 733 (Bankr. S.D. Tex. 2023). To read ABI’s report, [click here](#). Like Judge Lopez, she held:

A later event does not make a statement made as of the petition date incorrect. It does not change the eligibility as of the petition date. The debtor is either eligible or not. He does not change his existence during the case.

To bolster her holding, Judge Connelly pointed out the problems that would arise if eligibility were a continuing question. For example, obtaining post-petition financing could push the debtor’s debt above \$7.5 million. Or, dismissal of an affiliate’s case might make a sister debtor once again eligible for Subchapter V.



Judge Connelly ended her opinion by pointing out the advantages that Subchapter V bestows on creditors. In Subchapter V as opposed to “ordinary” chapter 11, creditors will have a larger recovery because the debtor pays no fees to the U.S. Trustee. Confirming a plan takes “appreciably” less time, and creditors benefit from the guidance of the Subchapter V trustee.

Judge Connelly denied the motion of the U.S. Trustee, finding that the debtors had established eligibility for Subchapter V.

[The opinion is](#) *In re Dobson*, 23-60148 (Bankr. W.D. Va. May 17, 2023).



The business debt necessary to qualify for Subchapter V need not to have arisen from the debtor's business at the time of filing, Bankruptcy Judge Meier says.

Student Loans Didn't Qualify as Commercial Debt for Sub V Eligibility

A bankruptcy court decision from Idaho seems to stand for the idea that educational loans obtained to earn a professional degree will not qualify as arising from “commercial or business activities” unless the debtor becomes the owner of a business not long after obtaining the degree.

The debtor in the Idaho case was precluded from pursuing reorganization under Subchapter V because her student loans weren't commercial or business debt and she was mostly an employee before filing in chapter 11.

However, the May 2 opinion by Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho, says that for debt to qualify for Subchapter V, it need not have arisen from the business that the debtor was conducting at filing.

The Student Loan Debt

The debtor had been an addiction counselor. Aiming to increase her income and provide more comprehensive services for her patients, she decided to attend medical school. After obtaining her medical degree and serving a residency, the debtor practiced medicine as an employee for several organizations over a space of 13 some years before bankruptcy. More than 10 years after obtaining her medical degree, the debtor opened her own practice for the first time, but it failed within a year. She was an employee at the time of filing.

The debtor filed a chapter 11 petition and elected to proceed under Subchapter V. By that time, the debtor's student loan debt, all obtained for the medical degree, had grown from \$325,000 to almost \$650,000 with interest. The student loans were substantially more than half of the debtor's total debt.

The U.S. Trustee objected to confirmation of the debtor's chapter 11 plan, arguing that the debtor was not entitled to proceed under Subchapter V. According to the objection, the student loan debt did not arise from “commercial or business activities.”

What Are Business Debts?



In his opinion on May 2, Judge Meier said that the plan met all of the prerequisites for confirmation, aside from eligibility for Subchapter V.

Section 1182(1)(A) governs eligibility. It says that a person is eligible for Subchapter V if the person is engaged in business or commercial activity and has debts not exceeding \$7.5 million. The section goes on to provide that “not less than 50 percent of” the debt must have arisen “from the commercial or business activities of the debtor.”

The U.S. Trustee conceded that the debtor was engaged in commercial or business activities on the petition date and that the debt did not exceed the ceiling for Subchapter V. If the student loans were commercial debt, more than half of the debt would have arisen from business activities.

With regard to eligibility and plan confirmation, Judge Meier said that the outcome would turn on whether the student loan debt was derived from commercial or business activities.

The debtor won a notable, preliminary skirmish. Judge Meier decided that the debt and the commercial activities need not be contemporaneous. He said, “[I]t would be rare for all of a debtor’s commercial or business debts to have been incurred on or around the petition date.”

Furthermore, the debt need not have arisen from the business that the debtor was conducting on the filing date. Judge Meier explained:

Congress left open the possibility that the commercial or business activities which gave rise to the debt might be different from the commercial or business activities the debtor was engaged in on the day the petition was filed.

Are Student Loans Commercial Debt?

Having decided that debt from years earlier was not disqualifying in itself, Judge Meier turned to the next question: Was the debtor was engaged in commercial or business activities on the filing date?

There was no disagreement, because the U.S. Trustee admitted that the debtor was engaged in business on the filing date. Judge Meier also said it was “not realistic” for the debtor to have opened her own practice after completing her residency.

Next, Judge Meier inquired as to “whether the debts arose from the Debtor’s commercial or business activities.” He framed the question as whether there must be a “nexus” between the “Debtor’s medical school student loan debt and the commercial or business activity she engaged in while she operated her own practice.” The case law, he said, “goes both ways.”



Judge Meier cited Bankruptcy Judge Thomas B. McNamara of Denver for the idea that the debt and the commercial activity must be contemporaneous. *See In re Ikalowych*, 629 B.R. 261, 275–76 (Bankr. D. Colo. 2021). To read ABI’s report on *Ikalowych*, [click here](#).

To decide whether the student loan debt arose from business activity, Judge Meier adopted the approach taken by Bankruptcy Judge Benjamin A. Kahn of Durham, N.C., who said that a debtor is engaged in business and commercial activity when the debtor is participating in the purchasing or selling of goods or services for a profit. *See In re Blue*, 630 B.R. 179, 189 (Bankr. M.D.N.C. May 7, 2021). To read ABI’s report on *Blue*, [click here](#). *See also In re Johnson*, 2021 WL 825156 at *7–8 (Bankr. N.D. Tex. March 1, 2021). To read ABI’s report on *Johnson*, [click here](#).

Judge Meier said it was “hard to conceive . . . that the debt incurred to attend medical school fully ten years before opening a business can be construed as ‘purchasing or selling of goods or services for a profit.’”

Although attending medical school “could potentially be construed” as purchasing goods or services, Judge Meier said that “such an interpretation would be a stretch.” He added:

The Debtor’s education had nothing to do with buying, selling, financing, or using goods, rather it gave Debtor the opportunity, as a person, to practice a profession.

For Judge Meier, it was “germane” that the

Debtor did not operate a private business before going to medical school and did not operate a business after obtaining her medical degree until more than a decade had passed. Rather, she was a student who hoped to gain employment following the conclusion of her studies and had aspirations of opening her own practice at some future time.

Judge Meier quoted Bankruptcy Judge Thomas P. Agresti of Erie, Pa., for saying that employment by someone else “would [not] be understood as thereby engaging in a commercial or business activity.” *In re Rickerson*, 636 B.R. 416, 426 (Bankr. W.D. Pa. 2021). To read ABI’s report on *Rickerson*, [click here](#).

“Here,” Judge Meier said, “the gap between incurring the debt and actually engaging in any sort of commercial or business activity as an owner is simply too great to find that the student loans at issue arose from Debtor’s commercial or business activities.” He therefore denied confirmation, holding that the “Debtor’s student loans do not qualify as business debts, rendering her ineligible to proceed as a Sub V debtor.”

Caveats



Judge Meier ended the opinion by narrowing the holding. He did “not foreclose all debt which arises prior to a business opening, [because] supplies, product, and a space for the business often must be acquired prior to the actual opening.”

Nor did Judge Meier “announce any sort of *per se* rule that student loan debt can never qualify as debt arising from commercial or business activities to satisfy Sub V eligibility.” In the case before him, though, the student loan debt, “incurred over ten years prior to opening the medical practice, is simply too far removed for Debtor to qualify for Sub V relief.”

The opinion is [In re Reis](#), 22-00517 (Bankr. D. Idaho May 2, 2023).



A district judge in Florida upheld a Subchapter V plan that required automatic increases in payments to unsecured creditors based on actual disposable income.

Sub V Plan Can Require Automatic Increases Based on *Actua/*Disposable Income

A cramdown plan in Subchapter V can require an individual debtor to calculate disposable income every quarter and to increase payments automatically to unsecured creditors if *actual* disposable income turns out to be more than *projected* disposable income, according to District Judge John E. Steele, who affirmed Bankruptcy Judge Caryl E. Delano of Tampa, Fla.

Pro se, the debtor confirmed a plan under Subchapter V of chapter 11 requiring \$150 monthly payments to unsecured creditors for five years. The plan provided that the payments to unsecured creditors “shall fluctuate based upon the Debtor’s actual disposable income remaining” after payments to senior creditors.

The plan went on to require the debtor to file quarterly operating reports showing actual disposable income. If actual disposable income were more than projected disposable income, the plan required automatically increased payments to unsecured creditors. If actual disposable income were less than \$150 per month, the plan still required the debtor to distribute \$150 *pro rata* to unsecured creditors.

To no avail, the debtor appealed the confirmation order entered by Bankruptcy Judge Delano, contending that the bankruptcy court had no statutory authority to base plan payments on actual disposable income rather than projected disposable income.

Evidently, the debtor confirmed a so-called cramdown plan because the debtor was required to comply with the “fair and equitable” standard in Section 1191(b). The term “fair and equitable” is defined in Section 1191(c).

“As of the effective date of the plan,” Section 1191(c)(2)(A) requires “that all of the projected disposable income of the debtor to be received [within five years of the first plan payment] will be applied to make payments under the plan.”

Although “projected disposable income” is not defined, “disposable income” is defined in Section 1191(d) to mean “income that is received by the debtor and that is not reasonably necessary to be expended” for domestic support obligations, for maintenance or support of the



debtors and dependents, and “for the payment of expenditures necessary for the continuation, preservation, or operation of the business of the debtor.”

“Requiring all the actual disposable income to be reported and distributed does not [violate] these statutory rules of construction,” District Judge Steele said in his January 6 opinion. He saw no conflict between the plan and Section 1191(d), because it is “simply” a definition of disposable income.

Judge Steele found authority for the floating payments in the Bankruptcy Code’s iteration of the All Writs Act found in Section 105(a). He affirmed the confirmation order because the floating payments “were clearly necessary and appropriate under the facts of this case.”

[The opinion is](#) *Staples v. Wood-Staples (In re Staples)*, 22-157 (M.D. Fla. Jan. 6, 2023).



Consumer Bankruptcy



Discharge/Dischargeability



The Fair Credit Reporting Act doesn't require credit reporting agencies to resolve disputed facts or law about the discharge of private student loans.

Second Circuit Limits the Significance of *Homaidan* on Discharge of Private Student Loans

If legal or factual disputes must be resolved before deciding whether a private student loan was excepted from discharge under Section 523(a)(8)(A)(i), there is no violation of the Fair Credit Reporting Act (FCRA) if the credit reporting agency shows the debt to be outstanding, according to the Second Circuit.

The January 4 opinion by Circuit Judge Alison J. Nathan limits the practical significance of *Homaidan v. Sallie Mae Inc.*, 3 F.4th 595 (2d Cir. July 15, 2021), where the Second Circuit held that private student loans are not excepted from discharge under Section 523(a)(8)(A)(ii). The only subset of private student loans excepted automatically from discharge are those falling under Section 523(a)(8)(B). To read ABI's report on *Homaidan*, [click here](#).

Cutting through the legal gibberish, the opinion could be read to mean that a credit reporting agency can show private student loans as not having been discharged without liability under the FCRA, 15 U.S.C. § 1681 *et seq.* However, credit reporting agencies may choose to be more circumspect, because Judge Nathan's opinion lists circumstances in which the facts and law could be sufficiently clear to result in liability for a faulty credit report.

Judge Nathan said that a student loan debtor "is not without options." She noted how the debtor could dispute the debt with the reporting agency, which, she said, "knows the nature of the loan program better than anyone else." Or, the debtor could obtain a clarification about discharge from the bankruptcy court.

The Student Loan at Issue

The debtor took down an \$18,000 loan from a private, for-profit corporation to attend a theological seminary. Because the school was not a Title IV institution, the debtor was not eligible for Stafford loans or other federal student aid.

The debtor received a bankruptcy discharge in 2013 and was immediately told by the servicer that the loan had not been discharged. In fact, the debtor signed a loan-modification agreement with the servicer and made payments for four years.



The servicer notified the credit reporting agency about the loan modification, noting that the debt was about \$20,000 and that some \$8,500 was past due.

Without filing a dispute with the reporting agency, the debtor sued the reporting agency in federal district court in New York a year or two after the last payment was made, alleging an FCRA violation. The district court granted the reporting agency's motion for summary judgment.

Despite what Judge Nathan said were disputed facts, the district court ruled that the debt had not been discharged, relieving the reporting agency of liability. The district court made its decision almost one year before the Second Circuit handed down *Homaidan*. The debtor appealed, leading Judge Nathan to affirm on other grounds.

The FCRA's Requirements

The standard for liability is contained in Section 1681e(b) of the FCRA, which says that credit reporting agencies "shall follow reasonable procedures to assure maximum possible accuracy of the information."

The debtor contended that the loan was not exempted from discharge under Section 523(a)(8)(A)(i), because it was not "made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution." For Judge Nathan, there was a factual dispute about whether the loan was funded "under any program funded in whole or in part by" by the government or a nonprofit institution.

Rather than resolve the factual issues like the district court, Judge Nathan affirmed "on the alternative ground that the legal inaccuracy alleged in this case is not cognizable under the FCRA."

Beyond the dispute about the type of "program" under which the loan was made, Judge Nathan found a need for interpreting Section 523(a)(8)(A)(i). She cited *Homaidan* for having rejected the idea that virtually all student loans are nondischargeable.

In addition, Section 1681e(b) of the FCRA requires reporting agencies to "follow reasonable procedures to assure maximum possible accuracy of the information concerning the individual about whom the report relates." She noted that "accuracy" is not defined in the statute.

Since there was no bankruptcy court order "explicitly discharging" the student loan, Judge Nathan said that the inaccuracy alleged by the debtor "does not meet this statutory test because it evades objective verification."

Focusing on the language of the FCRA, Judge Nathan said that the statute "does not require credit reporting agencies to adjudicate legal disputes such as the post-bankruptcy validity of [the



debtor's] educational loan debt." Furthermore, she found a legal dispute about whether the loan was nondischargeable under Section 523(a)(8)(A)(i).

That "unresolved legal question," Judge Nathan said, "renders [the debtor's] claim non-cognizable under the FCRA."

In sum, Judge Nathan held that "the post-bankruptcy validity of [the debtor's] debt means that its status is not sufficiently objectively verifiable to render [the debtor's] credit report 'inaccurate' under the FCRA."

Judge Nathan cited four other circuits for having held that "inaccuracies that turn on legal disputes are not cognizable under the FCRA."

Judge Nathan did not give reporting agencies a broad get-out-of-jail-free card. The opinion, she said, "does not mean that credit reporting agencies are never required by the FCRA to accurately report information derived from the readily verifiable and straightforward application of law to facts."

For example, she said that once a legal question is "sufficiently settled so that the import on a particular debt is readily and objectively verifiable, the FCRA sometimes requires that the implications of that decision be reflected in credit reports."

"What the FCRA does not require, however, is that credit reporting agencies resolve unsettled legal questions like the one at issue here," Judge Nathan said.

Before affirming the district court on other grounds, Judge Nathan listed some of the debtor's options: lodging a dispute with the reporting agency, and obtaining a declaration from the bankruptcy court regarding the discharge of the debt.

[The opinion is](#) *Mader v. Experian Information Solutions Inc.*, 20-3073 (2d Cir. Jan. 4, 2023).



The Ninth Circuit again questions the Supreme Court's 'atextual' analysis of Section 523(a)(7).

Ninth Circuit Invited to Sit *En Banc* Regarding Dischargeability of Disciplinary Costs

The Ninth Circuit and its Bankruptcy Appellate Panel have been at the forefront in criticizing *Kelly v. Robinson*, where the Supreme Court arguably departed from the language of the statute to achieve a socially desirable result. A panel of the Ninth Circuit appears to be urging a disbarred lawyer to file a motion for rehearing *en banc* where the appeals court could limit *Kelly* strictly to its facts and overturn Ninth Circuit precedent based on *Kelly*.

Kelly and its progeny interpret Section 523(a)(7), which provides that a debt is nondischargeable “to the extent such debt is for a fine, penalty, or forfeiture payable *to and for the benefit of* a governmental unit, and is *not compensation for actual pecuniary loss . . .*” [Emphasis added.]

The Supreme court held in *Kelly* that criminal restitution was nondischargeable under Section 523(a)(7), even though it was payable to the victim of the crime, because (1) the victim had no control over the decision to award restitution or the amount of the award, and (2) the decision to impose restitution turned on the penal goals of the state, not the victim’s injuries. *Kelly v. Robinson*, 479 U.S. 36 (1986). The high court based the decision on its “deep conviction that federal bankruptcy courts should not invalidate the results of state criminal proceedings.” *Id.* at 47.

In June 2020, Ninth Circuit Judge Patrick J. Bumatay upheld the nondischargeability of the costs of a lawyer’s disciplinary proceeding but reversed the BAP by holding that discovery sanctions were dischargeable. The appeals court also ruled that the state bar could condition reinstatement on payment of the nondischargeable debt.

In his opinion, Judge Bumatay said, “Like other relics of the 1980s, such as big hair, jam shorts, and acid-wash jeans, *Kelly*’s atextual interpretative method should not come back into fashion.” *In re Albert-Sheridan*, 960 F.3d 1188, 1195 (9th Cir. 2020). To read ABI’s report on *Albert-Sheridan*, [click here](#).

Before *Albert-Sheridan* went to the circuit, the BAP said in footnote seven that “*Kelly* seems to have been expanded to the point where the requirement that the fine or penalty must be payable ‘to and for the benefit of a governmental unit’ has been read out of the statute.” However, the appellate panel noted that Congress amended the Bankruptcy Code 33 times after *Kelly* but never legislatively overruled the Supreme Court’s interpretation of Section 523(a)(7). *Albert-Sheridan*



v. *Golden (In re Albert-Sheridan)*, 18-1222, 2019 BL 131713, 2019 Bankr. Lexis 1187, 2019 WL 1594012 (B.A.P. 9th Cir. Dec. 18, 2019). To read ABI's report on the BAP opinion, [click here](#).

The New Case

The opportunity for the Ninth Circuit to assess *Kelly* anew arose once again in the aftermath of attorney disciplinary proceedings.

A lawyer evidently had misappropriated clients' funds. The disciplinary tribunal in California disbarred the lawyer and directed him to pay about \$200,000 in restitution to 56 clients, along with some \$61,000 as costs of the disciplinary proceeding. In addition, the tribunal directed the lawyer to reimburse the state bar's client security fund for almost \$1.4 million that it paid to 305 other clients.

The lawyer filed a chapter 7 petition and received a general discharge. The lawyer filed a complaint in bankruptcy court contending that all of his debts arising from the disciplinary proceedings were discharged under Section 523(a)(7).

The bankruptcy court held that the \$200,000 was discharged because restitution was not payable to a governmental unit.

Interpolating *Kelly*, the bankruptcy court decided that the \$1.4 million was nondischargeable as a penalty imposed to further the state's interest in rehabilitating miscreant attorneys. Similarly, the bankruptcy court ruled that the \$61,000 was not dischargeable under *In re Findley*, 593 F.3d 1048 (9th Cir. 2010).

Findley is now in the Ninth Circuit's crosshairs. Here's how *Findley* came about.

Originally, the Ninth Circuit had held in *State Bar of California v. Taggart (In re Taggart)*, 249 F.3d 987 (9th Cir. 2001), that the costs of a disciplinary proceeding were dischargeable under Section 523(a)(7) because the costs were compensation for pecuniary loss.

In response, the California legislature amended the disciplinary statute to provide that the costs imposed on an attorney are "penalties" imposed "to promote rehabilitation and to protect the public."

Given the amended statute, the Ninth Circuit abandoned *Taggart* and held in *Findley* that disciplinary costs were nondischargeable because they were no longer compensation for pecuniary loss.



In the case involving the dischargeability of the \$61,000, \$200,000 and \$1.4 million, the bankruptcy court certified a direct appeal to the circuit. The Ninth Circuit accepted the appeal without an interim stop in district court or the BAP.

Reimbursement Is Dischargeable

On appeal, the state bar did not challenge the ruling that the \$200,000 awarded to the former clients was dischargeable. In his August 1 opinion, Circuit Judge Jay S. Bybee was charged with ruling on the dischargeability of the \$61,000 in costs and the \$1.4 million in reimbursement to the bar fund.

Regarding reimbursement of the \$1.4 million, Judge Bybee framed the issue under Section 523(a)(7) as whether the debt was a “fine, penalty, or forfeiture” and not “compensation for actual pecuniary loss.”

Reciting the history of *Taggart* and *Findley*, Judge Bybee said that the costs of a disciplinary proceeding are penal and rehabilitative and thus nondischargeable.

With the principles of *Findley* in mind, Judge Bybee analyzed the dischargeability of reimbursing the bar fund for the \$1.4 million it paid to the lawyer’s former clients. He trotted out several provisions in California law saying that reimbursement was designed to address pecuniary loss. “Considering the totality of the [reimbursement] program,” he held that “any reimbursement to the [fund] is payable to and for the benefit of the State bar and is compensation for the [fund’s] actual pecuniary loss, . . . even if reimbursement serves some penal or rehabilitative purpose.”

Arguably narrowing *Findley*, Judge Bybee said that his conclusion was “controlled by § 523(a)(7).” He reversed the bankruptcy court by holding that the obligation to reimburse the bar fund was dischargeable.

Costs Are Not Dischargeable

In less than one page, Judge Bybee dealt with the dischargeability of the \$61,000 in costs for the disciplinary proceeding. The lawyer conceded that the bankruptcy court was bound by *Findley*.

Tersely, Judge Bybee upheld the ruling of nondischargeability by saying, “We are bound by our decision in *In re Findley*.”

Seeming to invite a petition for rehearing *en banc*, Judge Bybee said, “If [the lawyer] wishes to pursue this issue, he must do so through a petition for rehearing *en banc*.”

[The opinion is](#) *Kassas v. State Bar of California*, 21-55900 (9th Cir. Aug. 1, 2022).



Bankruptcy Judge Christopher Klein provides authority for student loan debtors who win in bankruptcy court but face an appeal aimed at the trial court's fact-findings.

Judge Klein Charts the Path for Discharging Student Loans and Not Being Reversed

Bankruptcy Judge Christopher M. Klein decried the “widespread belief that student loans are virtually impossible to discharge in bankruptcy.”

In his April 5 opinion, Judge Klein said,

Only the most compelling cases seem to be able to qualify for discharge as “undue hardship” on a standard of proof that is preponderance of evidence.

It is now time, Judge Klein said,

to demythologize unwarranted and fallacious dogmas and propaganda that have encrusted, ossified, neutralized, and transmogrified § 523(a)(8) analysis into a misconception that student loan debt is virtually impossible to discharge, even though the “undue hardship” standard of proof is preponderance of evidence and the standard of appellate review is “clear error.”

As the “solution” for trial and appellate courts to reach the proper resolution in student loan cases, Judge Klein cited *U.S. Bank Nat’l Ass’n v. Village at Lakeridge*, 138 S. Ct. 960 (2018). Courts, he said, should follow “the Supreme Court’s explication of the proper roles of trial and appellate courts facing ‘mixed questions’ of law and fact and proper standard of review.” To read ABI’s report on *Lakeridge*, [click here](#).

Applying *Lakeridge*, Judge Klein said:

Student loan “undue hardship” questions depend intensely on the facts of each case. As such, they are mixed questions of law and fact in which factual questions predominate over legal analysis that must . . . be reviewed on appeal under the deferential “clear error” standard [T]he “clear error” standard . . . does not permit appellate courts to substitute judgment for that of the trial court. *Lakeridge*, 138 S. Ct. at 966-67.



Judge Klein, who sits in Sacramento, Calif., “is known for being a master of statutory analysis, and this opinion doesn’t disappoint,” said Prof. Nancy B. Rapoport. She said that he “points out that the question of undue hardship is a mixed question of law and fact, subject to review only for clear error.”

In commentary provided to the National Association of Chapter Thirteen Trustees, Prof. Rapoport described the case before Judge Klein as involving “the prototypical honest but (extremely) unfortunate debtor who tried her best to improve her position in life, but a rubbish heap of a university and a former abusive husband made it impossible for her to dig out of the hole of student debt.” Prof. Rapoport is a UNLV Distinguished Professor and the Garman Turner Gordon Professor of Law at the Univ. of Nevada at Las Vegas William S. Boyd School of Law.

The *Brunner* and *Pena* Tests

The opinion by Judge Klein is the definitive explication of the so-called *Brunner* test, taken from *Brunner v. New York State Higher Educ. Serv. (In re Brunner)*, 831 F.2d 395 (2d Cir. 1987), as adopted by the Ninth Circuit in *United Student Aid Funds, Inc. v. Pena*, 155 F.3d 1108 (9th Cir. 1998).

Applying the same standard, the courts in *Brunner* and *Pena* reached opposite conclusions. *Pena* discharged the debt, but *Brunner* didn’t. “The facts make all the difference,” Judge Klein said.

With regard to the first *Brunner* test — inability to maintain a minimal standard of living — the debtor’s income in *Pena* was \$41 short of covering expenses. When income and expenses fluctuate, the Ninth Circuit allowed the bankruptcy court to average the figures without being bound to accept the circumstances at the time of trial.

On the second *Brunner* test — “additional circumstances” indicating that the inability to maintain a minimal standard of living will persist — the Ninth Circuit in *Pena* did not require expert corroboration of the debtor’s medical problems. The appeals court found no clear error in the bankruptcy court’s finding that the debtor satisfied the second *Brunner* test.

On the third *Brunner* test — a “good faith” effort to repay the loan — the appeals court in *Pena* saw no clear error in finding good faith, because the debtor had made several payments.

Critique of Ninth Circuit Precedent

Judge Klein examined Ninth Circuit student loan cases in light of *Lakeridge*. Many appeals, he said, involved mixed questions of fact and law on the issue of “undue hardship.” Some courts, he said, paid “lip-service to ‘clear error’ but then [used] the ‘mixed question’ label as license to



nit-pick the trial court all the way to reversal in a manner that is the antithesis of ‘clear error’ review.”

Judge Klein parsed *Lakeridge* to discern how appellate courts should treat mixed questions of fact and law regarding “undue hardship.” In the unanimous *Lakeridge* opinion, he said that the Supreme Court gave a “master class” in assessing the standard of review when there are mixed questions of law and fact. *Lakeridge* teaches us how to choose between *de novo* and clear error.

Judge Klein quoted *Lakeridge* for saying that “the standard of review for a mixed question all depends . . . on whether answering it entails primarily legal or factual work.” *Lakeridge, supra*, 138 S. Ct. at 967.

Applying *Lakeridge* to student loan cases, Judge Klein said that the mixed question about undue hardship “immerses the court in case-specific factual issues. The controlling law — the *Brunner* test — is well known and needs little explication.”

Because the undue hardship question is “primarily factual,” Judge Klein said “it follows” that an appellate court should apply the “deferential ‘clear error’” standard of review.

Judge Klein identified two pre-*Lakeridge* decisions from the Ninth Circuit as being inconsistent with the “clear error” rule announced by the Supreme Court. *See Rifino v. U.S. (In re Rifino)*, 245 F.3d 1083 (9th Cir. 2001); and *Educ. Credit Mgmt. Corp. v. Mason (In re Mason)*, 464 F.3d 878 (9th Cir. 2006). He said they were both “garden-variety decisions in which a bankruptcy court found ‘undue hardship,’” but the appellate courts had reversed.

On the other hand, Judge Klein lauded *Hedlund v. Educ. Res. Inst. Inc.*, 718 F.3d 848, 854 (9th Cir. 2013), where he described the Ninth Circuit as having held that it was “error for an appellate court to substitute its judgment for that of the trial court on the question of *Brunner* ‘good faith.’” He cited the Seventh Circuit for reaching the same conclusion from the same reasoning.

Applying the Law to the Facts

After explicating the law on undue hardship, Judge Klein applied the law to the facts of the case before him. Prof. Rapoport aptly summarized the debtor’s economic circumstances above. The debtor had attended a now-defunct for-profit university to obtain a certificate that qualified her for nothing. She had an abusive husband who was convicted and jailed for beating her up. The expenses for herself and her two minor children exceeded her after-tax income. The judge saw no likelihood of an increase in the debtor’s income.

There being no requirement to exhaust administrative remedies, Judge Klein dismissed the government’s contention that the debtor should apply for relief under the Biden administration’s



attempts to provide relief for student loan debtors without amending the statute. He said there was only the “mere possibility” of administrative relief.

By a “preponderance of the evidence,” Judge Klein found that the debtor satisfied all three *Brunner* tests, entitling her to discharge all of her student loans under the Section 523(a)(8) undue hardship standard.

The opinion is *Love v. U.S. (In re Love)*, 21-02045 (Bankr. E.D. Cal. April 5, 2023).



*Milwaukee district judge rules that
bankruptcy does not cut off future liability
on a personal guaranty issued before
bankruptcy.*

Courts Split on Whether Bankruptcy Discharges Future Liability on a Guaranty

District Judge Brett H. Ludwig of Milwaukee stepped into the middle of a split by holding that an individual debtor's prior bankruptcy did not discharge liability on a personal guaranty for debts incurred after bankruptcy. Before ascension to Article III status in 2020, Judge Ludwig served three years on the bankruptcy bench.

Issued in favor of a particular supplier, the debtors had personally guaranteed any debt that might be owing by a restaurant they operated. The guaranty was "absolute, continuing and irrevocable."

In a no-asset case, the debtors filed a chapter 7 petition and received a discharge in 2014. However, the debtors had not scheduled what was a \$10,000 liability on the guaranty at the time of the chapter 7 filing. The supplier did become aware of the bankruptcy sometime after filing, according to the bankruptcy judge. The supplier did not file a proof of claim because none was required.

The restaurant incurred a \$40,000 debt to the supplier in 2018 that was not paid. The supplier reopened the debtors' chapter 7 case and filed an adversary proceeding to declare that the \$40,000 debt on the guaranty was not discharged. The supplier conceded that the \$10,000 debt was discharged.

Both sides moved for summary judgment. The bankruptcy court granted judgment in favor of the debtor, declaring in substance that all future liability on the personal guaranty had been extinguished by the 2014 discharge. *Reinhart FoodService LLC v. Schlundt (In re Schlundt)*, 20-02091, 2021 BL 314402, 2021 Bankr Lexis 2265 (Bankr. E.D. Wis. Aug. 19, 2021). To read ABI's report, [click here](#).

The bankruptcy judge sided with the Sixth Circuit Bankruptcy Appellate Panel, which had held that a pre-petition guaranty is a contingent claim that is discharged in a later bankruptcy. The bankruptcy court also took counsel from *Saint Catherine Hosp. of Ind. LLC v. Ind. Family and Soc. Servs. Admin.*, 800 F.3d 312 (7th Cir. 2015), where the Seventh Circuit adopted the so-called conduct test to determine whether a claim arose pre-petition or post-petition. In the bankruptcy court's opinion, relevant conduct was the signing of the guaranty before the 2014 bankruptcy.



The supplier appealed and won in Judge Ludwig's October 27 opinion.

Judge Ludwig trotted out the relevant statutes. Section 727(b) discharges “all debts that arose before” the order for relief. In turn, a “debt” means a liability on a claim under Section 101(12), and a “claim” under Section 101(5)(A) means a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”

Judge Ludwig said that the \$40,000 debt on the guarantee arose in 2018. Because “[t]here was no debt, claim or right to payment of any kind for this [\$40,000] prior to 2018” and “[b]ecause the liability did not arise until four years *after* the [debtors] filed their bankruptcy petition,” he held that the debt had not been discharged in the 2014 bankruptcy, “consistent with the plain terms of Section 727(b).”

Judge Ludwig characterized the guarantee as a “contractual promise,” which he said was “not the same thing” as a “debt.” He went on to say that “the mere existence of a promise or a contract does not necessarily create a legal liability.” In that respect, he said that bankruptcy discharges debts, “not promises . . . that arose before the bankruptcy petition was filed.”

Citing Section 101(12), Judge Ludwig said that “a debt exists only when there is liability on a claim.” He added, “The mere existence of a promise or contractual provision does not, in and of itself, create legal liability or, accordingly, a debt.”

Judge Ludwig said that the \$10,000 debt outstanding at the time of bankruptcy was discharged because it was an “existing liability” as of that time. But he said that “nothing in the Bankruptcy Code provides that the mere filing of a bankruptcy petition automatically terminates all of a debtor's existing contractual obligations.”

Judge Ludwig rejected the debtor's contention that obligations on the personal guarantee were “contingent” claims within the meaning of Section 101(5)(A) and were thereby discharged. From his point of view, “this stretches the meaning of a contingent claim almost beyond recognition.”

Ending his opinion, Judge Ludwig explained why *Saint Catherine* “does not compel the result” sought by the debtors. Laying out the Seventh Circuit case in detail, he said it involved “a unique Medicaid-reimbursement scheme, nothing like a pre-petition personal guarantee.” He said that none of the “general statements” in *Saint Catherine* about the “conduct test” required holding the debt to have been discharged.

Following the “plain text” of the Code and noting that the claim “depends almost entirely on post-petition conduct,” Judge Ludwig reversed the bankruptcy court with instructions to declare that the post-petition debt was enforceable.



The opinion is [Reinhart FoodService LLC v. Schlundt](#), 21-1027 (E.D. Wis. Oct. 27, 2022).



Dismissal



Two judges on the Sixth Circuit cast doubt on the validity of the doctrine of equitable mootness, even in chapter 11 reorganizations.

Sixth Circuit Staunches the Spread of Equitable Mootness to Chapter 7

Declining “the request to expand broadly an already questionable doctrine,” the majority on a Sixth Circuit panel held “that the doctrine of equitable mootness has no place in Chapter 7 liquidations.”

Short of a categorical holding, the language in the majority’s opinion by Circuit Judge Karen Nelson Moore has enough daylight to apply equitable mootness in an extraordinary chapter 7 case, perhaps on appeal from a highly complex settlement with hundreds of creditors who benefit from the settlement but are not before the appeals court.

Concurring in the judgment, Circuit Judge John B. Nalbandian would have ruled that the requirements of equitable mootness would not have been satisfied, even were the doctrine suitable for chapter 7. His opinion suggests that prior Sixth Circuit precedent would not have foreclosed the use of equitable mootness in chapter 7.

Complex Appeal – Simple Facts

Missteps by the creditor in the bankruptcy court and the district court’s misapprehension of the operative notice of appeal resulted in a procedural hash once the case reached the Sixth Circuit. For discussion of equitable mootness, the operative facts are simple.

The bankruptcy court granted a final allowance of compensation to a chapter 7 trustee. In the absence of a stay pending appeal, the trustee distributed the allowance to the trustee, and the bankruptcy court closed the case. The creditor appealed the closing of the case and the grant of compensation.

The district court dismissed the appeal on the grounds of both constitutional and equitable mootness. All three circuit judges agreed that the appeal was not constitutionally moot.

Constitutional Mootness



The district court found the appeal constitutionally moot for lack of a stay pending appeal. Writing for all three judges, Judge Nalbandian said, “Failing to seek a stay does not render an issue constitutionally moot,” because cases are reopened routinely.

Even absent a stay, Judge Nalbandian said that the bankruptcy court could have reopened the case and reconsidered the grant of compensation. Because the district court could have granted “effective relief,” the appeal was not constitutionally moot.

Equitable Mootness

For the majority, Judge Moore defined the question on appeal as “whether a court of review can decline to consider the merits and bar the appeal of an order issued in a Chapter 7 liquidation bankruptcy.”

Judge Moore said that equitable mootness does not flow from Article III standing principles but instead is a prudential doctrine. The three factors leading to a finding of equitable mootness are the lack of a stay pending appeal, substantial consummation and the effect on parties not before the court on appeal.

Equitable mootness first appeared in the Ninth Circuit in 1981 and later in the Seventh Circuit, Judge Moore said. The focus, she said, “remained on reorganization plans.”

The Sixth Circuit first applied equitable mootness in 1995. In the succeeding 20 years, Judge Moore said that Sixth Circuit “continued to apply equitable mootness to bar appeals only of confirmation orders of reorganization plans in Chapter 11 reorganizations.” In 2005 and 2008, she said that her appeals court again invoked the doctrine in chapter 11 reorganizations.

In Detroit’s municipal debt-adjustment in 2016, Judge Moore said that the Sixth Circuit applied the doctrine “specifically because of the complex nature of the reorganization before the panel.” She said there are “plenty of other courts and scholars” who say “that the complexity of the reorganization is a central tenet of the equitable-mootness doctrine.”

Judge Moore described equitable mootness as invoking “third-party reliance interests” and serving as a tool to ensure success of the reorganization.

“[I]n every instance in which this court has contemplated applying equitable mootness to bar review of the merits of an appeal,” Judge Moore said that “this court has remained committed to applying it narrowly — only contemplating barring appeals of confirmation orders of reorganization plans and inquiring into the complexity of the plan.”



“[T]hese concerns and rationales are not implicated in Chapter 7 liquidations,” Judge Moore said, because chapter 7 deals with simple liquidations where “ ‘there are rarely intricate transactions that need to be unraveled,’ ” quoting a commentator.

Observing that “no other circuit court has affirmatively embraced the equitable-mootness doctrine in Chapter 7 liquidations,” Judge Moore reversed and remanded with instructions for the district court to consider the merits of the appeal.

The Concurrence

Concurring in the judgment, Judge Nalbandian saw no reason to ban equitable mootness from chapter 7 cases because, even if applied, “the claim would not be equitably moot.”

Judge Nalbandian said that the Sixth Circuit had not ruled on the applicability of the doctrine in chapter 7. Contrary to the interpretation of the appeals court’s precedents by the majority, he referred to the finding of equitable mootness in Detroit’s municipal bankruptcy as showing “our circuit’s momentum is moving in favor of equitable mootness’s broad application.”

“[A]ny reversal of a Chapter 7 liquidation,” Judge Nalbandian said, “would likely be less difficult than the undoing of a Chapter 9 or 11 plan from the get-go.”

Even if applicable, equitable mootness would not kill the appeal, in Judge Nalbandian’s view, because “only professional fees are in dispute.” In the event of reversal, other creditors would benefit by returning more to the estate for distribution to creditors generally.

Like the majority, Judge Nalbandian would reverse and remand to consider the merits of the appeal from the grant of compensation.

[The opinion is](#) *Taleb v. Miller Canfield Paddock & Stone PLC (In re Kramer)*, 20-2273 (6th Cir. June 16, 2023).



In a case irreconcilable with two recent opinions from the Eleventh Circuit, the Fifth Circuit invokes Barton to bar a lawsuit against a trustee after the bankruptcy case had been closed.

Unlike the Eleventh Circuit, *Barton* Is Alive and Well in the Fifth Circuit

A stalwart defender of the *Barton* doctrine, the Fifth Circuit parted company with the Eleventh Circuit by permitting a bankruptcy trustee to invoke *Barton v. Barbour*, 104 U.S. 126 (1881), and prevail on the bankruptcy court to dismiss a suit brought against the trustee in state court.

In *Barton*, the Supreme Court held that receivers cannot be sued without permission from the appointing court. After adoption of the Bankruptcy Act of 1898, the doctrine was extended to cover bankruptcy trustees. *Barton* was subsequently broadened by many circuits to protect court-appointed officials and fiduciaries, such as trustees' and debtors' counsel, real estate brokers, accountants, and counsel for creditors' committees.

In two recent cases, the Eleventh Circuit theorized (incorrectly?) that bankruptcy jurisdiction is solely *in rem*, meaning that *Barton* protection expires when the bankruptcy case has been closed and there are no more estate assets. See *Tufts v. Hay*, 977 F.3d 1204 (11th Cir. Oct. 20, 2020), and *Chua v. Ekonomou*, 1 F.4th 948 (11th Cir. 2021). To read ABI's reports, [click here](#) and [here](#).

Bound by the two Eleventh Circuit cases, a bankruptcy court in Florida rebuffed a trustee's invocation of *Barton* and subjected the trustee to the tender mercies of state court when the bankruptcy case had been closed. See *In re Keitel*, 636 B.R. 845 (Bankr. S.D. Fla. Jan. 28, 2022). To read ABI's report, [click here](#).

The Fifth Circuit didn't let the same thing happen in a nonprecedential, *per curiam* opinion on January 3.

Similar Facts, Different Result

A wife filed a chapter 7 petition, listing three real properties among her assets. Three days later, she filed for divorce. Both by intervention in the matrimonial proceeding and by proceedings in bankruptcy court, the trustee contended that the properties belonged to the estate. Eventually, the bankruptcy court decided that the properties did belong to the estate and authorized a sale.



Years passed, the trustee filed a final report, and the bankruptcy court approved final fee allowances and the final report, discharged the trustee and closed the case. By definition, there were no remaining estate assets when the case closed. Under the Eleventh Circuit's view, there could be no *Barton* protection.

Ten months later, the wife-debtor attempted to reopen the bankruptcy case to set aside the judgment regarding the properties. The bankruptcy court refused to reopen the case.

Without permission from the bankruptcy court, the wife-debtor filed suit in state court against the trustee, the trustee's counsel and her (former) husband. The trustee reopened the bankruptcy case and, along with the other defendants, removed the suit to bankruptcy court.

The bankruptcy court disagreed with the wife, found jurisdiction, and dismissed the suit against the trustee and counsel. For lack of jurisdiction, the bankruptcy court remanded the suit to state court with respect to the husband. The district court affirmed.

Plentiful Jurisdiction

The Fifth Circuit panel said there was "related to" jurisdiction and that claims against the trustee and counsel were "core," since they could not have arisen outside of bankruptcy. Because the claims by the wife arose from the trustee's exercise of duties, the panel said it was "meritless" to argue that the bankruptcy court had no power to enter final judgment.

The wife contended that removal was untimely because the defendants did not file notices of removal within 30 days of the mailing of the state court complaint. The circuit panel rejected the argument, because removal occurred less than 30 days after receipt of the complaint, the deadline imposed by Bankruptcy Rule 9027(a)(3).

Applicability of *Barton*

The bankruptcy and district courts both concluded that *Barton* applied and that the defendants had immunity. The Fifth Circuit agreed about *Barton* — first, because the bankruptcy court had jurisdiction, and second, because the trustee's actions were not *ultra vires*, given that they were part of the trustee's official duties and were undertaken in accordance with court orders.

The panel affirmed, holding that dismissal was proper under *Barton*. Having dismissed, the panel saw no reason to analyze whether the trustee and counsel were entitled to immunity.

Observations



The Fifth Circuit's opinion cited neither of the *Barton*-limiting decisions from the Eleventh Circuit. The results nonetheless seem irreconcilable, especially in view of *Keitel*, which declined to invoke *Barton* on similar facts.

The Fifth Circuit doesn't merely apply *Barton* reverentially to cases factually on point. Indeed, the Fifth Circuit recently cited *Barton* as authority for a dramatic expansion of the bankruptcy court's power to supervise and dismiss state court lawsuits after the conclusion of a chapter 11 case. See *NexPoint Advisors LP v. Highland Capital Management LP (In re Highland Capital Management LP)*, 21-10449, 2022 BL 291525, 2022 US App Lexis 23237, 2022 WL 3571094 (5th Cir. Aug. 19, 2022).

In a circuit that does not permit nondebtor releases in chapter 11 plans, the Fifth Circuit in *Highland Capital* held that a chapter 11 plan may give the bankruptcy court a gating function to approve or disapprove the commencement of lawsuits against participants in the reorganization, even those not entitled to exculpation. Furthermore, *Highland Capital* said that the bankruptcy court has power, should there be jurisdiction, to pass on the merits of a suit someone would wish to bring outside of bankruptcy court.

As authority for gatekeeping, *Highland Capital* cited *Barton*, saying that “[c]ourts have long recognized [that] bankruptcy courts can perform a gatekeeping function.” To read ABI's report on *Highland Capital*, [click here](#).

[The opinion is](#) *Foster v. Aurzada (In re Foster)*, 22-10310 (5th Cir. Jan. 3, 2023).



*Ruling the other way would have
barred chapter 13 filings after renewing
title loans.*

Renewing a Title Loan Just Before Chapter 13 Didn't Make the Filing in Bad Faith

On remand from the district court, Bankruptcy Judge Bess M. Parrish Creswell of Montgomery, Ala., defused an attempt by a title lender to establish a legal principle that would bar individuals from filing chapter 13 petitions after renewing loans secured by the titles to their automobiles.

To argue that the debtors had not filed their petitions and plans in good faith, the title lender contended that the debtors had violated the following provision in the standard loan agreement:

[The borrower] represents, warrants, acknowledges and agrees . . . [that the borrower is] not a debtor in bankruptcy [and does] not intend to file a federal bankruptcy petition.

Bankruptcy Judge William R. Sawyer had confirmed the debtors' chapter 13 plans, but the title lender appealed. District Judge R. Austin Huffaker, Jr., reversed and remanded with instructions to reconsider whether the debtors filed their plans in good faith. In particular, Judge Huffaker wanted an analysis of the tenth *Kitchens* factor. See *In re Kitchens*, 702 F.2d 885 (11th Cir. 1983) (*per curiam*). To read ABI's report on the district court opinion, *TitleMax of Alabama Inc. v. Arnett*, 21-00840 (M.D. Ala. Aug. 22, 2022), [click here](#).

Ending his opinion, District Judge Huffaker said he expressed "no view as to what impact, if any, such reconsideration might have on the ultimate issue of whether the debtors proposed their plans in good faith."

The Three Debtors

In reconsidering confirmation of three debtors' chapter 13 plans, the critical facts were identical.

All three debtors had first taken down title loans months before bankruptcy and renewed them month by month. Each had renewed the loans for the last time on the day before filing or the day following. They had all consulted bankruptcy lawyers before renewing their loans or had taken the required credit management courses before renewing.



The loans had not matured on the day the debtors filed their petitions.

Inheriting the case on Judge Sawyer's retirement, Judge Creswell said in her March 16b opinion that the debtors had a *combined* net monthly income after expenses of less than \$800. None were serial filers, and there was no evidence that the lender had asked any of them about filing bankruptcy before they renewed their loans the last time. None of the debtors took down additional loans when they renewed.

Judge Creswell said that all three "were in obviously precarious financial conditions seeking to reorganize multiple debts (not just those of [title lender]) and to obtain the financial relief and fresh start bankruptcy offers."

The lender objected to confirmation, contending that the debtors had not filed their plans in good faith and that the loans were void for fraud.

The Scylla and Charybdis in Eleventh Circuit Law

Two Eleventh Circuit precedents loomed over the cases: *TitleMax v. Northington (In re Northington)*, 876 F.3d 1302 (11th Cir. 2017), and *TitleMax of Ala., Inc. v. Womack (In re Womack)*, No. 21-11476, 2021 BL 326887, 2021 US App Lexis 26127, 2021 WL 3856036 (11th Cir. Aug. 30, 2021) (*per curiam*).

In *Northington*, the pawn loan had expired before bankruptcy. Once in chapter 13, the debtor did not redeem the car within the prescribed time, as extended by Section 108(g). The appeals court held that the car dropped out of the estate automatically, leaving the debtor no ability to keep the car and pay off the loan in chapter 13.

In *Womack*, the debtor had filed the chapter 13 petition before the loan matured. Because the estate included ownership of the car and not a mere right to redeem, the Eleventh Circuit allowed the debtor to retain the car and restructure the debt in chapter 13.

To avoid having the three debtors fall under *Womack*, the title lender cited Section 1325(a)(3) and (a)(7), contending that the filings and the plans were not in good faith in view of the representations that bankruptcy was not in the offing.

Good Faith

With regard to the lender's contention that the loans were void for fraud, Judge Creswell said that the lender had not specified whether it was actual fraud or fraudulent inducement. Furthermore, she said that the lender "did not set forth or address the necessary elements to prove fraud."



Therefore, Judge Creswell dealt with the fraud allegations as objections to confirmation. First, she tackled good faith in filing the petitions.

From the evidence, Judge Creswell said that the debtors' financial conditions were "dire" and that "they could benefit from bankruptcy relief." Because the determination of good faith is based on "the totality of the circumstances," she said that "pre-petition conduct alone is not determinative on the issue of good faith."

With regard to the representations that they were not filing bankruptcy, Judge Creswell found no basis in the record to "conclude . . . that these Debtors were intentionally deceptive or that they even understood the timing issues at play between *In re Northington* and *In re Womack*."

Based on the preponderance of the evidence, Judge Creswell found that the debtor had filed in good faith. She was "not persuaded that Debtors' use of the protections provided by the Bankruptcy Code and precedent in the Eleventh Circuit equates to 'unmistakable manifestations of bad faith.'"

Filing the Plan in Good Faith

As requested by the district court, Judge Creswell examined the 11 *Kitchens* factors one by one. She said that "most" were "undisputed" and that they weighed in favor "of finding good faith."

Among other considerations, Judge Creswell said that the debtors had not filed in chapter 13 solely to retain their cars.

Judge Creswell devoted most of her attention to the tenth *Kitchens* factor, "which looks at the circumstances under which a debtor has contracted his debts and demonstrated his bona fides in dealings with creditors." The lender, she said, "centers its argument on the timing" of the final renewal of the loans.

Although she could not ignore the timing, Judge Creswell observed that the debtors were not new customers of the lender. She said "there was no evidence presented that Debtors understood the potential effects the timing of the pawn renewal would have on [the lender's] rights in bankruptcy."

In view of the "totality of the circumstances," Judge Creswell overruled the objections and confirmed the plans, finding as follows:

[These records do] not reveal egregious misconduct, abuse, or bad faith to warrant such treatment. Debtors did not approach a new creditor asking for an unsecured loan with intent to not pay it back; instead, Debtors refinanced prior debts and proposed to pay the refinanced amounts with pawn shop fees and interest



as secured debts over the life of their Chapter 13 plans. While the renewals of the pawn agreements were close in time to the filing of the bankruptcy petitions, in viewing the totality of the circumstances, the facts support that Debtors are sincere in seeking to reorganize their debts. The evidence and testimony do not support that Debtors entered into the contracts with no intentions to perform. Debtors are not seeking to thwart their debts; instead, Debtors are repaying their debts to [the lender] and their other creditors as permitted by the Bankruptcy Code and Eleventh Circuit precedent. In doing so, they should be afforded the opportunity of a fresh start.

[The opinion is](#) *In re Roby*, 21-30731 (Bankr. M.D. Ala. March 16, 2023).



The Ninth Circuit BAP interprets circuit authority as giving a chapter 13 debtor the absolute right to dismiss.

Even if Ineligible for Chapter 13, the Debtor Still Has an Absolute Right to Dismiss

Concluding that recent Ninth Circuit authority gives the debtor an absolute right to dismiss a chapter 13 case, the Bankruptcy Appellate Panel for the Ninth Circuit held “that ineligibility to be a chapter 13 debtor does not deprive the debtor of the near-absolute right to dismiss the chapter 13 case.”

The debtor was sued by his former employer for breach of a noncompetition and nondisclosure agreement, along with misappropriation of trade secrets. The former employer won a judgment for about \$215,000. The employer recorded the judgment to obtain a lien on the debtor’s real property.

The debtor filed a chapter 13 petition, listing some \$87,000 in unsecured debt plus \$950,000 in secured debt, including \$364,000 owing to the former employer.

The employer filed an adversary proceeding in bankruptcy court alleging that the debt was nondischargeable as a willful and malicious injury to property or a fraud while acting in a fiduciary capacity. The employer also alleged that the debtor transferred property fraudulently to his former wife, to shield assets from creditors. In addition, the employer objected to the debtor’s homestead exemption alongside a motion to value the property.

The debtor responded by moving to dismiss the chapter 13 case under Section 1307(b). The former employer opposed dismissal, arguing that dismissal would further the debtor’s wrongdoing.

Of greater weight, the former employer contended that the debtor had too much unsecured debt for chapter 13 and therefore should be considered a chapter 7 debtor, where dismissal is not automatic.

Bankruptcy Judge Natalie M. Cox of Las Vegas overruled the objection and permitted dismissal. The former employer appealed again, losing a second time in an October 21 opinion for the BAP by Bankruptcy Judge Robert J. Faris.

The Split on Dismissal

The controlling statute is Section 1307(b), which provides, “On request of the debtor at any time, . . . the court *shall dismiss* a case under this chapter.” [Emphasis added.]



Interpreting that section, the Second, Sixth and Ninth Circuits give a chapter 13 debtor a seemingly absolute right to dismiss a chapter 13 case that has not been previously converted from chapters 7, 11 or 12. In the Ninth Circuit, the case is *Nichols v. Marana Stockyard & Livestock Market Inc. (In re Nichols)*, 20-60043, 2021 BL 368629, 2021 Us App Lexis 29302 (9th Cir. Sept. 1, 2021). To read ABI's report on *Nichols*, [click here](#).

On the other side of the fence, the Fifth and Eighth Circuits held that dismissal under Section 1307(b) may be conditioned on the debtor's good faith. Those circuits rested their opinions in part on *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), where the Supreme Court held under Section 706(a) that the bankruptcy court has discretion to deny conversion of a chapter 7 case to chapter 13 as a consequence of the debtor's bad faith. However, those decisions came down before *Law v. Siegel*, 571 U.S. 415 (2014), where the Supreme Court held that a bankruptcy court may not use its equitable powers under Section 105(a) to contravene express provisions of the Bankruptcy Code.

Arguably, *Law* cut the ground out from underneath the Fifth and Eighth Circuits' decisions on Section 1307(b).

Dismissal Notwithstanding Bad Faith

In the Ninth Circuit before *Nichols*, the governing authority had been *Rosson v. Fitzgerald (In re Rosson)*, 545 F.3d 764 (9th Cir. 2008), where the appeals court upheld denial of a motion to dismiss under Section 1307(b) and conversion to chapter 7.

Judge Faris pointed out that "the Ninth Circuit's recent *Nichols* decision overruled *Rosson* and made clear that chapter 13 debtors have an absolute right to dismiss their case at any time, so long as the case had not been previously converted." In other words, *Rosson* was no longer good law after *Law*.

Judge Faris held that the text of Section 1307(b) gives the debtor an absolute right to dismiss, if there has not been a prior conversion.

The employer contended that *Nichols* was not controlling because the debtor had too much debt for chapter 13. Judge Faris was willing to accept that contention, for the sake of argument.

If he were to deny dismissal because the debtor had too much debt for chapter 13, Judge Faris said that he "would create a new limitation, not found in § 1307(b), on the debtor's absolute right to dismiss a chapter 13 case. This is exactly what *Law* forbids."



Judge Faris added, “Nothing in the text of § 1307(b) limits voluntary dismissal to only “eligible” debtors.” Because the debtor’s case had not been converted, he affirmed the bankruptcy court for allowing dismissal.

At the end of his opinion, Judge Faris alluded to the statement in *Nichols* that the bankruptcy court has “other tools” to deal with abuse. An example, he said, would be imposing a bar to refiling or other conditions under Section 105(a).

Observation

Could “another tool” be sanctions under Bankruptcy Rule 9011(c)(1)(A)?

[The opinion is](#) *Tico Construction Co. v. Van Meter (In re Powell)*, 22-1014 (B.A.P. 9th Cir. Oct. 21, 2022).



Plans & Confirmation



Although the chapter 13 confirmation order was concededly final and enforceable, the appeals court set aside a plan provision modifying a residential mortgage.

Dubious Eleventh Circuit Opinion Permits Collateral Attack on Final Confirmation Order

At the risk of oversimplification, the Eleventh Circuit held that a final, enforceable order confirming a chapter 13 plan could not be enforced to the extent that the plan violated Section 1322(b)(2) by impermissibly modifying the mortgage on the debtor's principal residence.

In her January 10 opinion, Circuit Judge Robin S. Rosenbaum declined to follow *United Student Aid Funds Inc. v. Espinosa*, 559 U.S. 260 (2010), where the Supreme Court held that a chapter 13 plan must be enforced even though it improperly discharged a student loan. Judge Rosenbaum appeared to interpret *Espinosa* as applicable only when a final, confirmed plan has been attacked under Federal Rule 60(b)(4).

Although it was "too late" for the mortgage lender "to alter the Plan," Judge Rosenbaum said it was "not too late for [the lender] to invoke the Code's special protection for homestead mortgagees."

This writer reads the Eleventh Circuit's opinion to mean that the lender could mount a successful collateral attack on one of the provisions in the plan, although the plan was final, enforceable and could not be altered.

The opinion seems based on the idea that the anti-modification clause in Section 1322(b)(2) is one of the preeminent provisions in chapter 13 that cannot be overcome by an erroneous but final order confirming a plan. Granted, anti-modification is central to chapter 13, but the erroneous discharge of debt that the Supreme Court upheld in *Espinosa* is the single-most important form of relief sought by a debtor.

This writer has two questions: (1) Will any other circuits follow the Eleventh; and (2) how many other terms in confirmed plans (chapter 11 included) can be set aside belatedly by using the Eleventh Circuit's logic?

One thing is for sure: Counsel in the Eleventh Circuit will not use Rule 60(b)(4) in the future to cover their tracks when they forget to object to confirmation. This rule is applicable in bankruptcy cases through Bankruptcy Rule 9023.



Facts in the Eleventh Circuit

Just like with *Espinosa*, the case in the Eleventh Circuit was replete with mistakes, principally by the secured lender. In *Espinosa*, the student loan lender neglected to object to the chapter 13 plan that discharged a student loan without the required showing of “undue hardship.”

In the Eleventh Circuit case, the debtor took down a \$14,000, nine-year mortgage on her home at 19.7% interest. The next year, the debtor filed a chapter 13 petition. The mortgage lender filed a secured proof of claim stating that the debt was some \$6,800, the arrears on the mortgage. The claim did not include the principal balance of the loan.

The debtor filed a chapter 13 plan acknowledging that the mortgage debt was more than \$17,000. The 58-month plan earmarked about \$450 a month to be paid to the lender through the trustee, or about \$26,000 in total. The debtor’s monthly payment to the trustee for all claims was about \$500, including the lender’s \$450. The plan called for lenders to retain their liens until the completion of all plan payments.

The mortgage lender did not object to the plan, nor did the lender file a corrected proof of claim.

About two years after confirmation, the chapter 13 trustee filed a notice that the cure payments of \$6,800 had been paid in full and that the entire mortgage debt had been satisfied. The debtor filed a motion asking the court, in substance, to require the lender to deliver a satisfaction of the mortgage.

The lender objected, contending that the debtor had paid nothing toward the balance due on the mortgage of about \$15,000. The lender also asked the court to modify the automatic stay.

The bankruptcy court granted the debtor’s motion to deem the mortgage as having been satisfied. The district court affirmed. The lender appealed to the circuit.

The Primacy of Section 1322(b)

Section 1322(b)(2) says that a chapter 13 plan may not modify a mortgage “secured only” by the debtor’s principal residence.

Judge Rosenbaum spent the better part of her 39-page opinion justifying the (obvious) conclusion that the “Plan unlawfully purported to modify [the lender’s] rights as a homestead mortgagee.” She found three instances in Section 1322 where Congress “expressly or implicitly protected from modification the rights of homestead-mortgage lenders.”



From the Supreme Court, Judge Rosenbaum found support primarily in *Nobelman v. Am. Savs. Bank*, 508 U.S. 324 (1993), where the Court barred a chapter 13 debtor from bifurcating a secured lender's claim when the collateral was worth less than the debt. Like the Supreme Court, she focused on the language in Section 1322(b)(2) that prohibits modifying the lender's "rights" rather than the lender's "claims" alone.

Among Eleventh Circuit precedent, Judge Rosenbaum followed *Universal Am. Mortg. Co. v. Bateman (In re Bateman)*, 331 F.3d 821 (11th Cir. 2003). Decided before *Espinosa*, *Bateman* held that a confirmed plan could not discharge the debtor from all of the arrears owed on a mortgage, in view of the anti-modification rule in Section 1322(b)(2).

"So while it's true" that the lender's claim sought only \$6,800, Judge Rosenbaum said that "nothing about that claim . . . changed the fact that [the lender] was entitled under the terms of the mortgage and Alabama law to receive full payment on the balance of its loan."

Bateman Survived *Espinosa*

While it may be true that the plan should have paid the principal amount of the mortgage, it's a fact that the lender didn't object and that the confirmation order was final. The debtor argued that *Espinosa* controlled and effectively overruled *Bateman*.

Indeed, Judge Rosenbaum cited Section 1327(a) and conceded that the plan was final, even though it did not comply with the Bankruptcy Code and "should not have been confirmed." The plan, she said, "retains preclusive effect and is therefore valid and enforceable."

Judge Rosenbaum said that the lender should have objected to the plan and should have filed a corrected proof of claim.

However, Judge Rosenbaum gave five reasons why *Espinosa* did not apply and did not abrogate *Bateman*. Most prominently, she said that *Espinosa* was decided under Federal Rule 60(b)(4) and therefore "has no bearing on the release of a lien after a confirmed plan erroneously modifies a homestead-mortgagee's rights." In the case on appeal, the lender was not contending that the confirmation order was void under Rule 60(b)(4).

Judge Rosenbaum said that *Bateman* arose "in a significantly different procedural posture." Factually, she said that the lender in the case on appeal had not brought the challenge "years after the fact," compared to *Espinosa*.

To this writer, the Eleventh Circuit seems to have held that *Espinosa*'s bar to a collateral attack on a final order only applies if the attack was under Rule 60(b)(4).

The Holding



Here's the noteworthy holding in Judge Rosenbaum's opinion:

[The lender's] errors do not change the fact that the Code still affords special protections to homestead-mortgage holders' rights. So even though our cases have recognized the importance of finality, they have also said time and again that secured liens survive bankruptcy proceedings. [Citations omitted.]

Here's the second-most noteworthy statement of the holding:

While the finality provision confirms that it is too late to alter the Plan, it is not too late for [the lender] to invoke the Code's special protection for homestead mortgagees.

Judge Rosenbaum held that the mortgage survived the debtor's bankruptcy, allowing the lender to collect the full mortgage balance, because the "Plan could not legally modify those rights."

Because the lender did not object on appeal to the discharge granted by the bankruptcy court, Judge Rosenbaum said in a footnote that the appeals court would not "disturb that decision." The footnote seems to mean that the debtor will have no personal liability on the mortgage, although the lender can enforce the mortgage against the home.

[The opinion is](#) *Mortgage Corp. of the South v. Bozeman (In re Bozeman)*, 21-10987 (11th Cir. Jan. 10, 2023).



Contributions to 401(k) plans are deducted from 'projected disposable income,' even though the debtor was not making contributions before filing.

Judge Isgur Allows 401(k) Contributions in Chapter 13 Up to What the IRS Code Allows

Courts are split three ways on whether chapter 13 debtors can make contributions to 401(k) plans. Some courts permit none whatsoever, while others permit contributions no larger than what the debtor was contributing before bankruptcy.

Bankruptcy Judge Marvin Isgur of Houston took the third approach by allowing contributions up to the amount permitted by the IRS Code, regardless of whether the debtor had been making contributions before filing the chapter 13 petition.

So far, only one circuit has spoken on the topic. In *Davis v. Helbling (In re Davis)*, 960 F.3d 346 (6th Cir. 2020), the Sixth Circuit rejected the holding by some courts that contributions are never included in “disposable income,” whether or not the debtor was making contributions before bankruptcy. The majority in *Davis* held that a debtor who was making contributions to a 401(k) before bankruptcy may continue making contributions in the same amount by deducting the contributions from disposable income.

The dissenter in *Davis* would have held that a debtor cannot make contributions after bankruptcy, even if he or she was making them beforehand. To read ABI’s report on *Davis*, [click here](#).

In a unanimous opinion the next year, the Sixth Circuit held that a chapter 13 debtor may not make 401(k) contributions if the debtor had not been making contributions before bankruptcy, even if (1) the debtor had a history of making contributions in prior years when he was able, and (2) the debtor was not eligible for a 401(k) plan in the months before bankruptcy. *Penfound v. Ruskin (In re Penfound)*, 7 F.4th 527 (6th Cir. Aug. 10, 2021). To read ABI’s report on *Penfound*, [click here](#).

Judge Isgur’s Debtor

A husband and wife filed a chapter 13 petition. Only the husband, age 58, was employed. They had not been making contributions to the husband’s 401(k) plan before filing. In fact, they had been forced to take almost \$12,000 in loans from the 401(k).



The plan was designed to have a 24% recovery for unsecured creditors. The plan called for the debtors to contribute \$1,700 a month to the 401(k) plan. The contribution was less than the IRS Code permits but more than the amount matched by the husband's employer.

The chapter 13 trustee objected to confirmation, contending that the debtors were improperly deducting the 401(k) contributions from disposable income, lowering the recovery for unsecured creditors. The trustee also argued that the contributions meant that the plan was not filed in good faith.

Deducting Contributions from Disposable Income

In his April 6 opinion, Judge Isgur first tackled the question of whether 401(k) contributions are deducted from projected disposable income.

The Bankruptcy Code only defines “disposable income,” not “projected disposable income.” In Section 1325(b)(2), “disposable income” means “current monthly income received by the debtor . . . less amounts reasonably necessary to be expended.”

To define what “projected” adds to the equation, *Hamilton v. Lanning*, 560 U.S. 505 (2010), comes into the equation. The Court said that “the court may account for changes in the debtor’s income or expenses that are known or virtually certain at the time of confirmation.” *Id.* at 524.

“Whether 401(k) contributions are a permissible adjustment hinges on further interpretation of the Code,” Judge Isgur said.

Next, Judge Isgur dealt with Sections 541(a) and 541(b). The former brings assets into the estate, while Section 541(b) excludes some assets from the estate. Judge Isgur spent the better part of his opinion deciding whether Section 541(b) excludes assets from the estate only at the time of filing or if it also excludes assets from the estate that come to the debtor after filing.

The so-called hanging paragraph in Section 541(b)(7) further complicates the question. First, the subsection excludes employee benefit and deferred benefit plans from the estate. That portion of the section clearly excludes 401(k)s from the estate that the debtor owns on filing. But does it also shield salary that the debtor will receive after filing but intends to contribute to a 401(k)?

The hanging paragraph may have been intended to clarify the meaning as to contributions after filing, but lousy drafting only made matters worse. The hanging paragraph at the end of Section 541(b)(7) says:

except that such amount under this subparagraph shall not constitute disposable income, as defined in section 1325(b)(2).



Judge Isgur decided that Section 541's "plain language" means that the exclusions in Section 541(b) "do apply to property acquired after" filing. He cited the *Collier* treatise for the same interpretation. He went on to say that the "best interpretation of the Code's text and purpose excepts post-petition 401(k) contributions from the debtors' disposable income."

To bolster his conclusion, Judge Isgur noted that Section 1306(a) "modifies § 541 generally, not just one subsection of § 541." He therefore concluded that Section 1306(a) "should be read to incorporate § 541(b)'s exceptions as well as modify § 541(a)'s inclusions." Furthermore, he said that Section 541(b) "contains no qualifiers or language indicating its application is limited either by time or to a specific section."

Reading Sections 1306 and 541 together, Judge Isgur held that they should be "read together to subject a chapter 13 debtor's post-petition wages to the exception for 401(k) contributions in § 541(b)(7)."

How Much to Exclude?

Having decided that 401(k) contributions can be deducted from disposable income, Judge Isgur asked, "How much?"

Surveying cases going every which way, Judge Isgur said that the "more common view is that any amount of the debtor's post-petition income can be contributed to a 401(k), so long as that contribution is made in good faith," approvingly citing another bankruptcy judge in the Southern District of Texas.

In Judge Isgur's way of thinking, only nonbankruptcy law constrains how much a debtor can contribute. From the point of view that contributions are not estate property, he said that the bankruptcy court has no authority to regulate the use of nondebtor property.

Was the Plan Filed in Good Faith?

Although the Bankruptcy Code has no limitation on 401(k) contributions, the Code does require that plans be filed in good faith.

Judge Isgur said it was "difficult to find a lack of good faith" when the debtor planned on contributing less than the IRS Code permits, but the trustee contended there was no good faith because the 401(k) contributions were "unreasonably high" compared to what creditors were receiving and because the debtor had not been contributing before bankruptcy.

Judge Isgur rejected these contentions, saying that "increasing 401(k) contributions above the amount contributed before bankruptcy is expressly allowed by the Code, and doing what is allowed by the Code cannot be evidence of bad faith."



Given the husband’s poor health and “low pre-petition savings,” Judge Isgur said that the desire to “save as much as possible now is reasonable, particularly in light of the forward-looking nature of chapter 13.”

Judge Isgur added a caveat in confirming the plan: The debtors could deduct the contributions from disposable income as long as they were actually making the contributions. He required the debtors to include a special provision in the plan calling for periodic reports to the trustee showing that the debtors were making the 401(k) contributions.

The opinion is [In re Perkins, 22-20025 \(Bankr. Tex. April 6, 2023\)](#).



The Fourth Circuit agreed with the Sixth and Ninth Circuits by allowing chapter 13 debtors to deduct their actual mortgage expenses, not limited by the local standard mortgage deduction.

'13' Debtors May Deduct their Actual Mortgage Expenses to Arrive at Disposable Income

The chapter 13 debtors' monthly mortgage payment was \$1,100 more than the local standard mortgage deduction. Abjuring a split of circuits, the Fourth Circuit held that debtors with above-median income can deduct the actual amount of their mortgage payments when calculating disposable income.

Upholding Bankruptcy Judge Stephanie W. Humrickhouse on direct appeal, the June 14 opinion by Circuit Judge Toby J. Heytens sided with the Sixth and Ninth Circuits.

The Mortgage and Official Form 122C-2

A couple filed a chapter 13 petition, owning a home with a monthly mortgage payment of some \$2,200. They calculated their disposable income on Official Form 122C-2. Subtracting the entire monthly mortgage payment, they ended up with disposable monthly income of \$253 earmarked for creditors.

The chapter 13 trustee objected, contending that the debtors could only deduct about \$1,100, the local standard deduction for home mortgages. The trustee believed that the debtors should be paying another \$1,100 to their creditors every month.

Bankruptcy Judge Humrickhouse of Raleigh, N.C., overruled the objection and confirmed the plan. When the trustee appealed, Judge Humrickhouse certified a direct appeal to the Fourth Circuit. The appeals court accepted the direct appeal.

The Complex Statute

Judge Heytens said that the "relevant statutory provisions — though intricate — are straightforward." The answer to the appeal lay in the complex interrelationship among the subdivisions in Section 707(b)(2).

Without tracking all of the detail meticulously laid out by Judge Heytens, the answer is buried in Section 707(b)(2)(A)(iii)(I). The subsection says that debtors' "average monthly payments on



account of” their mortgages “shall be calculated” based on the amounts “contractually due to secured creditors.”

Next, Section 707(b)(2)(A)(i) says that debtors “reduce[]” their “current monthly income” “by the amount[] determined under” Section 707(b)(2)(A)(iii)(I).

The answer, Judge Heytens said, is “easy-peasy” and yields disposable income of \$253.

The trustee offered “a flurry of arguments against this straightforward reading,” Judge Heytens said. He described the arguments as failing “multiple times over.”

In addition to allowing a deduction for the contractually due mortgage payments, Judge Heytens explained that Section 707(b)(2)(A)(iii)(I) “allows debtors to deduct ‘any additional payments to secured creditors necessary for the debtor . . . to maintain possession of the debtor’s primary residence.’” He said that the provision “cannot be squared with the trustee’s view that the means test could leave debtors . . . with insufficient funds to pay their mortgage in the first place.”

As a matter of public policy, the trustee wanted the court to impose a reasonableness test. Like the Ninth Circuit, Judge Heytens recognized that his interpretation of the statute could allow debtors to retain expensive homes and luxury items, yielding little disposable income for creditors.

Judge Heytens saw “at least” two sides to the policy argument. On the other side of the coin, he said that the statute supplanted the previous practice allowing courts to evaluate the reasonableness of expenses. The result, he said, was inconsistent determinations.

Affirming Bankruptcy Judge Humrickhouse, Judge Heytens declined “to interpret the statute to restore the very power Congress removed.”

C.V. of Judge Heytens

After law school, Judge Heytens clerked on the Third Circuit and then for Supreme Court Justice Ruth Bader Ginsburg. He was an assistant U.S. solicitor general after his clerkships and was Virginia’s Solicitor General before nomination to the Fourth Circuit by President Biden. He was also a professor of law at the University of Virginia.

[The opinion is *Bledsoe v. Cook*, 22-1328 \(4th Cir. June 14, 2023\).](#)



Compensation



The Ninth and Tenth Circuit disallow fees to chapter 13 trustee if the case is dismissed before confirmation. The identical issue is sub judice in the Second Circuit.

Two Circuits Now Hold: '13' Trustees Aren't Paid if Cases Dismiss Before Confirmation

Joining the Tenth Circuit, the Ninth Circuit also has held that chapter 13 trustees are *not* paid their fees when cases are dismissed before confirmation. The identical issue was argued on February 15 before the Second Circuit.

In short order, we'll have either unanimity or a split of circuits. A split will give rise to an issue worthy of a grant of *certiorari* by the Supreme Court.

Notably, the Ninth Circuit's opinion on June 12 adopted reasoning in an *amicus* brief filed in support of the debtor by the National Consumer Bankruptcy Rights Center and National Association of Consumer Bankruptcy Attorneys.

Lower Court Rulings

A couple filed a chapter 13 petition. After dismissing the case voluntarily before confirmation, the debtors filed a motion asking the bankruptcy court to have the chapter 13 trustee disgorge the fees that she had retained.

Chief District Bankruptcy Judge Joseph M. Meier of Boise, Idaho, decided that the statutes were ambiguous and concluded that a chapter 13 trustee is paid only if a plan is confirmed. *See In re Evans*, 615 B.R. 290 (Bankr. D. Idaho Feb. 13, 2020). To read ABI's report, [click here](#).

On appeal, the district court reversed, found no ambiguity in the statute, and held that "§ 1326(a)(2) does not direct the Trustee to return it if confirmation does not happen." *McCallister v. Evans*, 637 B.R. 144, 150 (D. Idaho Feb. 8, 2022). To read ABI's report, [click here](#).

The debtors appealed to the Ninth Circuit.

The Relevant Statutes

The fees of chapter 13 trustees are not to be a burden on taxpayers nor on the budget of the U.S. courts. To be paid by chapter 13 debtors, the trustees' fees are determined by



the Attorney General under the criteria specified in 28 U.S.C. § 586(e)(1). Sometimes read in favor of paying trustees in all circumstances, 28 U.S.C. § 586(e)(2) says that a standing trustee “shall *collect* such percentage fee from all payments . . . under [chapter 13] plans . . .” [Emphasis added.]

Debtors rely on Section 1326(a)(2) of the Bankruptcy Code, which provides that payments made by the debtor “shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b).”

Section 1326 (a)(2) does not explicitly say what happens to a trustee’s fees when the case is dismissed before confirmation.

The chapter 13 trustee relied on the definition of “collect” in *Black’s Law Dictionary* to mean “receive payment.” The debtor wanted the Ninth Circuit to read “collect” to mean “collect and hold.”

In his decision for the Court of Appeals, Circuit Judge Milan D. Smith, Jr. said that the *amici* had the “better approach.”

The Twomey Interpretation

Judge Smith paraphrased the *amici* for positing “that the phrase ‘payments . . . under plans’ in Section 586, when read in the larger context of the Bankruptcy Code, refers only to payments under *confirmed* plans, rendering the provision irrelevant to the *pre-confirmation* period.” [Emphasis in original.] He retold how the *amici* said that “the place to look is instead Sections 1326(a) and (b).”

Proffering his own interpretation, Judge Smith said that “Section 1326(a)(1)(A) refers to payments ‘*proposed by the plan*,’” while Section 586 “refers to ‘payments . . . under plans.’”

“Accordingly,” Judge Smith said, “prior to confirmation, a trustee does not ‘collect’ or ‘collect and hold’ fees under Section 586, but instead ‘retains’ payments ‘proposed by the plan’ pursuant to Section 1326(a)(2).” If the plan is not confirmed, he said that “Section 1326(a) requires return of ‘any such payments’ . . . to the debtor, after deducting amounts previously paid and due and owing to creditors.”

Saying that “[w]e generally agree with” the *amici*, Judge Smith read Section 1326(b) as indicating “that a standing trustee can be paid her percentage fee only after confirmation.”

Holding that trustees are not paid if dismissal precedes confirmation, Judge Smith said that the “plain text of Section 1326(b) unambiguously shows that it is the specific provision governing



when a trustee ‘shall be paid’: ‘before or at the time of each payment to creditors under the plan,’ which necessarily means post-confirmation of a plan.”

Further lauding the *amici*’s reading of the statutes, Judge Smith said that their “interpretation is consistent with the opinion of the only other circuit to reach this issue,” citing the Tenth Circuit in *Goodman v. Doll (In re Doll)*, 57 F.4th 1129 (10th Cir. 2023). To read ABI’s report on *Doll*, [click here](#). [Note: The Tenth Circuit denied motions for rehearing and rehearing *en banc*, and also denied a motion to stay the issuance of the mandate pending a petition for *certiorari* to the Supreme Court. Time remains for the trustee to file a petition for *certiorari*.]

Other Theories

To assuage doubt about his interpretation of the statutes, Judge Smith pointed to chapter 12 and Subchapter V of chapter 11, which, he said, “have language almost identical to Section 1326(a), but explicitly mandate that fees be paid to trustees regardless of plan confirmation.” Those statutes, he said, “show that Congress knew how to explicitly require payment of trustee fees in the event of non-confirmation . . . and suggest that it intentionally chose not to require the same in the Chapter 13 context.”

With regard to policy, Judge Smith mentioned the trustee’s contention that disallowing fees in dismissed cases would unfairly shift the burden onto debtors whose cases are not dismissed. However, he noted that the “policy was only changed recently.” Trustees were first permitted to collect fees prior to confirmation in 2012 and weren’t allowed to collect on receipt until 2014.

“Notably,” Judge Smith referred to the Executive Office for the U.S. Trustee’s *Handbook for Chapter 13 Standing Trustees*, which tells trustees to reverse payment only if there is controlling law in the district. He said that the “Trustee’s policy arguments are not enough to overcome the plain language and context of the relevant statutory provisions, which indicate that standing trustees are only to be paid once a plan is confirmed.”

Updates

In the Eastern District of New York, Bankruptcy Judge Robert E. Grossman ruled that a chapter 13 trustee is entitled to compensation if the case is dismissed before confirmation. *See In re Soussis*, 624 B.R. 559 (Bankr. E.D.N.Y. Nov. 12, 2020). To read ABI’s report, [click here](#). Judge Grossman was affirmed in district court. *See Soussis v. Macco*, 20-05673, 2022 WL 203751 (E.D.N.Y. Jan. 24, 2022). To read ABI’s report on the district court opinion in *Soussis*, [click here](#).

The debtor appealed. Oral argument was held in the Second Circuit on February 15. The debtor in *Soussis* immediately gave the Second Circuit a copy of the Ninth Circuit decision.



Recently, Bankruptcy Judge Timothy A. Barnes of Chicago denied compensation in a dismissed case and certified the question to the Seventh Circuit for direct appeal. *See In re Johnson*, 650 B.R. 904 (Bankr. N.D. Ill. May 12, 2023). To read ABI's report, [click here](#). The Seventh Circuit has yet to accept or reject a direct appeal.

The opinion is *Evans v. McCallister (In re Evans)*, 22-35216 (9th Cir. June 12, 2023).



The first court of appeals to rule on a question where lower courts are split, the Tenth Circuit finds the statute unambiguous and requires a chapter 13 trustee to disgorge his or her fee if the case is dismissed before confirmation.

Tenth Circuit Doesn't Pay '13' Trustee if Dismissal Precedes Confirmation

The first court of appeals to rule on a question where the lower courts are widely split, the Tenth Circuit held that a chapter 13 trustee was not entitled to payment of her fee because the case was dismissed before confirmation of a plan.

Although the Bankruptcy Code does not expressly answer the question, the January 18 opinion by Circuit Judge David M. Ebel found the statutes to be unambiguous, in favor of requiring trustees to disgorge fees if the chapter 13 case was dismissed before confirmation. He was particularly persuaded to rule in favor of the debtor because the Bankruptcy Code explicitly says that trustees retain their fees in Subchapter V and chapter 12 if the case was dismissed before confirmation.

Typical Facts

The facts were typical of cases where the courts come down both ways. The debtor filed a chapter 13 petition and slogged through four iterations of a plan over 18 months. After the bankruptcy court denied confirmation of the fourth plan, the court dismissed the case.

While the case was pending, the debtor had paid the trustee almost \$30,000 toward what would have been distributions to creditors and other plan payments. Following dismissal, the chapter 13 trustee paid the debtor's counsel almost \$20,000 on an allowed fee application and distributed another \$7,500 in payment of a priority tax claim. Toward partial payment of the chapter 13 trustee's fee, the bankruptcy court allowed the trustee to retain the remainder, some \$2,600.

With \$2,600 in controversy, the debtor appealed. The district court reversed in December 2021, requiring the chapter 13 trustee to refund the \$2,600 to the debtor. *Doll v. Goodman (In re Doll)*, 21-00731, 2021 BL 464213, 2021 WL 5768991 (D. Colo. Dec. 6, 2021). To read ABI's report, [click here](#).

Supported by an amicus brief from the National Association of Chapter 13 Trustees, the chapter 13 trustee appealed. The debtor found support in an *amicus* brief from three organizations on the side of debtors.



The Statute Is Not Ambiguous

Admirably, Judge Ebel traced the history of chapter 13 trustees, how they were delegated responsibilities previously thrust on courts, and why they were given fixed fees rather than allowances to be made by the court in every case. He explained how and why the fees paid to chapter 13 trustees are too low in some cases and too high in others.

Judge Ebel laid out the relevant statutes, particularly 28 U.S.C. § 586(e) and Section 1326(a)(1) and (a)(2).

Section 586(e) says that a standing trustee “shall *collect* such percentage fee from all payments . . . under [chapter 13] plans. . . .” [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor “shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b).” The subsection says nothing explicitly about the standing trustee’s fee if the case was dismissed before confirmation.

Judge Ebel said that the “question presented here is resolved unambiguously by reading together both 28 U.S.C. § 586 and 11 U.S.C. § 1326.” He added that the language in Section 1326(a)(2) is “straightforward.”

He read Section 1326(a)(2) “to mean that the standing trustee must return all of the pre-confirmation payments he receives, without first deducting his fee.” He found “no indication in this statutory language that the trustee should first deduct his fees before returning the pre-confirmation payments to the debtor when no plan is confirmed.”

Judge Ebel “bolstered” his conclusion by noting how Congress expressly allowed trustees in chapter 12 and Subchapter V cases to retain their fees if the cases were dismissed before confirmation. *See* Sections 1194(a) and 1226(a). He found the “differing treatment” of chapter 13 trustees to be “compelling” and “persuaded [him] that Congress intended that Chapter 13 standing trustees not deduct their fees before returning pre-confirmation payments to the debtor when a plan is not confirmed.”

Drawing inferences from the differences in the statutes, Judge Ebel said:

Giving effect to §§ 1194(a)(3) and 1226(a)(2)’s express direction that standing trustees in Chapter 12 and Chapter 11 (Subchapter V) cases should deduct their fees from pre-confirmation payments before returning them to the debtor when no plan



is confirmed suggests that Congress did not intend Chapter 13 standing trustees to do the same where such language is omitted.

Judge Ebel held that:

11 U.S.C. § 1326(a), read together with 28 U.S.C. § 586(e)(2), and considered in light of the different language in 11 U.S.C. §§ 1194(a)(3) and 1226(a)(2), unambiguously require the standing Chapter 13 trustee to return pre-confirmation payments to the debtor without the trustee first deducting his fee, when a proposed Chapter 13 reorganization plan is not confirmed.

Judge Ebel ended his opinion rejecting arguments proffered by the trustee that had been espoused by other courts ruling to the contrary.

The word “collect” in Section 526(e) “cannot mean,” Judge Ebel said, “that the act of ‘collection’ of funds irrevocably constitutes a payment to the Trustee of his fees.” Likewise, he said that language in the *Chapter 13 Trustee Handbook* was “hardly the exercise of agency expertise in interpreting an ambiguous statute or filling a regulatory gap left by Congress to which a court usually defers.”

Judge Ebel ended his opinion by saying that he “need not decide here whether the Handbook is entitled to any sort of deference because the statutory language at issue here is unambiguous.”

Recent Contrary Authority

The district and bankruptcy courts are split. In a decision last year, a district court in Idaho found no ambiguity in the statute but concluded that the trustee was entitled to retain the fee. *See McCallister v. Evans*, 637 B.R. 144 (D. Idaho Feb. 8, 2022). To read ABI’s report, [click here](#).

[The opinion is](#) *Goodman v. Doll (In re Doll)*, 22-1004 (10th Cir. Jan. 18, 2023) (rehearing and rehearing *en banc* denied April 27, 2023).



Seventh Circuit to Rule on Paying '13' Trustees if Dismissal Precedes Confirmation

Bankruptcy Judge Timothy A. Barnes of Chicago certified a question for the Seventh Circuit to decide on direct appeal: May a chapter 13 trustee be paid her fee if the case is dismissed before confirmation?

So far, only the Tenth Circuit has ruled on the issue, coming down on the side of the debtor by holding that a trustee may not be paid when dismissal precedes confirmation. The same question is now pending in appeals to the Second and Ninth Circuits.

We invite our readers to wager on whether there will be unanimity or a split among the circuits.

Typical Facts

The chapter 13 debtor toiled through eight unsuccessful confirmation hearings until the U.S. Trustee ultimately prevailed on a motion to dismiss. Alongside dismissal, Judge Barnes granted the debtor's counsel's fee application.

Before the clerk closed the case, the debtor filed a motion to compel the chapter 13 trustee to disgorge the fees that the trustee had retained before returning the balance of the plan payments that the debtor had given the trustee before dismissal.

The chapter 13 trustee objected to the disgorgement motion, but Judge Barnes ruled in favor of the debtor in his May 12 opinion. The judge said that his decision "marks a significant change in the practice of the chapter 13 trustees in this District, if not this Circuit," because chapter 13 trustees in Chicago have routinely retained their fees in cases dismissed before confirmation.

Judge Barnes recognized the economic significance of the issue for chapter 13 trustees. In 2019, for instance, he said that 21% of the district's 18,000 cases were dismissed before confirmation, meaning that the trustees would not be paid in thousands of cases.

Judge Barnes Follows the Tenth Circuit

Judge Barnes said that the case involved "pure statutory interpretation." The outcome pits two statutes against each other.



In favor of paying the trustee, Section 586(e) says that a standing trustee “shall *collect* such percentage fee from all payments . . . under [chapter 13] plans. . . .” [Emphasis added.]

In favor of the debtor, Section 1326 (a)(2) provides that payments made by the debtor “shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b).”

Judge Barnes said it’s “clear” what happens to payments by the debtor once a plan is confirmed, but it’s “not as clear” about the chapter 13 trustee’s compensation when the case is dismissed before confirmation. In Chicago, though, he said it was the “tried-and-true practices of the chapter 13 trustee” to retain their fees even if the cases were dismissed before confirmation.

Judge Barnes cited cases coming down both ways. However, he found the Tenth Circuit to be “persuasive” in disallowing a trustee’s compensation when a plan is not confirmed before dismissal. See *Goodman v. Doll (In re Doll)*, 57 F.4th 1129 (10th Cir. 2023). In *Doll*, the Denver-based appeals court held:

11 U.S.C. § 1326(a), read together with 28 U.S.C. § 586(e)(2), and considered in light of the different language in 11 U.S.C. §§ 1194(a)(3) and 1226(a)(2), unambiguously require the standing Chapter 13 trustee to return pre-confirmation payments to the debtor without the trustee first deducting his fee, when a proposed Chapter 13 reorganization plan is not confirmed.

Id. at 1144. To read ABI’s report on *Doll*, [click here](#). The Tenth Circuit denied motions for rehearing and rehearing *en banc*, and also denied a motion to stay the issuance of the mandate pending a petition for *certiorari* to the Supreme Court.

Like *Doll*, Judge Barnes ruled in favor of the debtor by holding that the “Trustee must follow the express language of section 1326(a)(2) and return to the Debtor all collected payments still held by the Trustee at the time his case was dismissed, unless excepted from doing so by the express conditions of section 1326(a)(2).” Therefore, he said, the “Trustee is not authorized to deduct from held plan payments her statutory fee if a chapter 13 case is dismissed without confirmation of a plan.”

Certification of a Direct Appeal

Judge Barnes recognized that the Second and Ninth Circuits are on the cusp of deciding the same question in appeals from district courts in Idaho and New York. See *McCallister v. Evans*, 637 B.R. 144 (D. Idaho 2022), and *Soussis v. Macco*, 20-05673, 2022 WL 203751



(E.D.N.Y. Jan. 24, 2022). In both cases, the trustees prevailed. To read ABI's reports on *McCallister* and *Soussis*, [click here](#) and [here](#).

Sua sponte, Judge Barnes certified a direct appeal to the Seventh Circuit under 28 U.S.C. § 158(d)(2)(A). He said it was “a matter of public importance,” and “there is no controlling decision of the court of appeals in this Circuit or of the Supreme Court.”

Sua sponte, Judge Barnes also stayed enforcement of his opinion pending a decision from the Seventh Circuit.

[The opinion is](#) *In re Johnson*, 22-04449 (Bankr. N.D. Ill. May 12, 2023).



Judicial Liens



The Ninth Circuit dissenter interpreted the statute to mean that the debtor must pay a tax lien twice if the lien was avoided and preserved.

Ninth Circuit Splits on Avoiding and Preserving a Lien on Exempt Property

To avoid forcing a debtor to pay the same tax lien twice, the majority on a Ninth Circuit panel held that a trustee may not avoid a lien securing a tax penalty and preserve the avoided lien for the estate, if the lien had attached to exempt property.

Although the tax lien would have been avoidable had it attached to nonexempt property under Section 724(a), the majority concluded that the lien could not be avoided as to exempt property under Section 726(a)(4) because the home was no longer estate property.

The dissenter saw the tax lien as avoidable and preservable because the entire home, including the exempt portion, was estate property *on the filing date*.

Warning: Reading this story and the opinions likely will cause brain cramps or narcolepsy.

Simple Facts

The debtor owned a home but did not file a return or pay taxes for 2015. The Internal Revenue Service assessed taxes plus penalties and interest. The debtor subsequently paid the taxes but not the penalties and interest.

The IRS recorded a tax lien to secure payment of the penalties.

Six weeks after the IRS filed the lien, the debtor filed a chapter 7 petition and claimed a homestead exemption of up to \$150,000 under Arizona law. Her state opted out of federal exemptions. The exemption was allowed.

Based on the tax lien, the IRS filed a secured claim of almost \$25,000.

The trustee moved to avoid the tax lien under Section 724(a) and preserve the lien for the estate under Section 551. The IRS and the debtor both objected, but the bankruptcy court avoided and preserved the lien. The district court affirmed.

While the appeal was pending in the Ninth Circuit, the debtor found a buyer for the home. The



bankruptcy court approved the sale for \$475,000, enough to pay off the mortgage. From the surplus after paying the mortgage and costs, the bankruptcy court directed the trustee to hold almost \$27,000 to abide the outcome of the appeal. From the sale proceeds, the court gave the debtor some \$30,000, representing the value of her homestead exemption from the net proceeds after setting aside the \$27,000.

In other words, the entire equity in the home would have been exempt even if there were no tax lien.

The Majority Reverses

Sitting by designation and writing for the majority, District Judge Edward M. Chen of San Francisco reversed the lower courts, holding that the trustee could not avoid and preserve the lien.

Nonetheless, Judge Chen ruled in his November 18 opinion that the debtor took her exempt interest in the proceeds subject to the tax lien.

As a result, the IRS will be paid, but the debtor won't pay twice.

Estate Property Evolves After Filing

The trustee moved to avoid the tax lien under Section 724(a) because it secured “a claim of a kind specified in section 726(a)(4).”

Section 726(a)(4) encompasses a secured or unsecured claim “for any fine, penalty, or forfeiture . . . to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss” Section 551 provides that a lien avoided under Section 724(a) “is preserved for the benefit of the estate *but only with respect to property of the estate.*” [Emphasis added.]

To reverse the lower courts, the majority also relied on the portion of Section 726(a) that says that “*property of the estate* shall be distributed . . . (4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture . . . [that is] not compensation for actual pecuniary loss suffered” [Emphasis added.]

Everyone agreed that the tax lien fell within the definition of an avoidable lien under Section 724(a) but disagreed about whether the lien was avoidable.

True, the entire homestead became estate property on filing under Section 541(a), but Judge Chen said that property interests of the estate “evolve.” Specifically, he said that allowance of an exemption withdraws property from the estate and reverts the property in the debtor.



Judge Chen went on to say that “§ 724(a) applies to property that is part of the estate at the time of distribution based on its express reference to § 726(a)(4).” For him, it was “clear from the express language of § 724(a) and its cross-reference to § 726(a)(4) . . . that § 724(a) concerns the trustee’s avoidance of qualifying liens attached to the *property of the estate* at the time of *distribution*.” [Emphasis in original.]

“When a debtor properly exempts a property interest under § 522,” Judge Chen said, “the exemption withdraws that property interest from the estate and, thus, from the reach of the trustee for distribution to creditors.” The exempted property, he said, reverts in the debtor and is no longer property of the estate.

“[B]ecause exempt property is not ‘property of estate’ which may be ‘distributed,’” Judge Chen held that “a trustee may not avoid a lien under § 724(a) (that secures the kind of claim specified in § 726(a)(4)) attached to exempt property which is no longer part of the estate.” More plainly, he held that “§ 724(a) does not permit a trustee to avoid a tax lien secured by exempt property because such securing property is not property of the estate.”

Applying the holding to the facts, Judge Chen said that the debtor was entitled to exempt up to \$150,000 from the net proceeds. “However,” he said, the debtor takes her exempt interest subject to the IRS’s tax lien under *DeMarah v. United States*, 188 B.R. 426, 431 (E.D. Cal. 1993), *aff’d*, 62 F.3d 1248 (9th Cir. 1995).

If the lien were avoided and preserved, Judge Chen said it would be “a troubling result” because the debtor would pay the same debt twice — first, by taking the \$27,000 out of her exemption for the benefit of creditors, and second, because the lien would remain attached to the diminished proceeds that the debtor would receive from the sale. He said that the debtor’s “fresh start would hardly be served by doubling the burden of the previously existing tax lien on the debtor.”

“That the dissent’s interpretation of the statute produces such a perverse result provides powerful reason to reject that interpretation,” Judge Chen said.

The Dissent

Circuit Judge Patrick J. Bumatay “respectfully” dissented. He said that the majority’s desire to avoid a “troubling result” overrode the statute and nullified the trustee’s avoiding power.

Judge Bumatay said that “the answer here is simple: a trustee may avoid a federal tax lien and preserve it for the benefit of the estate.” The court should have “easily affirmed,” he said.



The majority’s notion about the evolution of the estate was “mistaken,” Judge Bumatay said. The Bankruptcy Code, as he reads it, says that property of the estate under Section 541(a) encompasses property “as of the commencement of the case.”

The homestead exemption, Judge Bumatay said, does not remove the entire homestead or tax lien from the estate. Citing Ninth Circuit precedent, he said that a debtor’s interest in property at the commencement of the case is property of the estate regardless of whether the debtor claims an exemption.

Addressing the majority concern about double payment, Judge Bumatay said that he could not “circumvent the plain text of the Bankruptcy Code.” He would have affirmed.

Observations

The following are the writer’s opinions:

Respectfully, Judge Bumatay misreads Section 541(a).

For the purposes of a chapter 7 case, the section defines estate property to include property owned by the debtor on the filing date to show that property acquired by the debtor after filing does not go into the estate. If property on the filing date, for example, were to remain estate property throughout, property sold during the case would remain estate property.

Similarly, the majority’s logic is questionable.

Respectfully, it is a stretch to say that Section 726(a) precludes a trustee from avoiding a lien on exempt property. The section serves other purposes.

To this writer’s way of thinking, the case is a perfect example of the fallacy in trying to divine an answer from statutory provisions designed to accomplish other objectives. Applying a statute to questions for which it was not intended can give an answer, but not necessarily the best answer.

In a case such as this, applying policy evident in the overall statute points in the right direction. As the dissenter appears to admit, allowing avoidance and preservation would have the debtor pay the same debt twice. Surely, that’s not what Congress intended. Indeed, it is clear to this writer that Congress did not contemplate the question that the appeals court was answering.

In a case like this, policy and common sense have a place in making decisions when the statute has no evident answer.

[The opinion is](#) *U.S. v. Warfield (In re Tillman)*, 21-16034 (9th Cir. Nov. 18, 2022).



When avoiding a judgment lien under Section 522(f), state law cannot dictate that the amount of the exemption is the amount in effect when the lien was created.

Avoiding a Judgment Lien that Impairs an Exemption Is Theoretical, Ninth Circuit Says

Believe it or not: Even if state law says that the amount of an exemption is the amount in effect when the lien was created, the Bankruptcy Code allows the debtor to avoid the lien under Section 522(f) based on the amount of the exemption at the time of the bankruptcy filing, according to the Ninth Circuit.

The debtor in California was hit with a judgment for about \$250,000 in 2014. The judgment became a lien on the debtor's home.

California has opted out of federal exemptions. In 2014, the state homestead exemption was only \$75,000.

The debtor filed a chapter 7 petition in 2021, claimed a homestead exemption and scheduled his home as being worth about \$1.1 million. By the time of filing, the judgment lien had risen to about \$475,000 with interest.

The value of the home wasn't the only thing that had risen in seven years. Before the filing date, California raised the applicable homestead exemption to \$600,000. However, California law provides that the amount of an exemption is the amount in effect at the time the lien is created.

The debtor moved to avoid the lien as impairing his homestead exemption under Section 522(f). The debtor calculated that \$550,000 in mortgages on the home plus his \$600,000 exemption and the \$475,000 judgment totaled about \$1.6 million. The total was about \$540,000 more than the debtor's interest in the home.

Because the \$540,000 was more than the \$475,000 judgment lien, the debtor contended that he could avoid the entire judgment lien as impairing his homestead exemption.

The judgment lien creditor objected, arguing that the applicable homestead exemption under state law should be \$75,000, the amount of the exemption when the lien was created. Under the lien creditor's theory, the debtor could only avoid about \$45,000 of the judgment lien.



Chief Bankruptcy Judge Christopher B. Latham of San Diego agreed with the debtor and avoided the entire judgment lien. Judge Latham certified a direct appeal, which the Ninth Circuit accepted.

The appeals court heard argument on September 23 and affirmed on November 14 in an opinion by Circuit Judge Holly A. Thomas.

The Supreme Court's *Owen* Controls

As Judge Thomas said, the outcome turned on the language of Section 522(f), which says that a debtor may avoid a judgment lien to the extent that the lien “impairs an exemption to which the debtor *would have been entitled*.” [Emphasis added.]

The Supreme Court interpreted the italicized language in *Owen v. Owen*, 500 U.S. 505 (1991).

Under Section 522(f), Judge Thomas said that *Owen* “requires courts to determine the exemption to which the debtor would have been entitled but for the existence of the judicial lien at issue. 500 U.S. at 310-11.” She quoted portions of *Owen* that said that Section 522(f) measures impairment not by the amount of the exemption to which the debtor is entitled, but by the amount to which the debtor would have been entitled were it not for the judgment lien. *Id.*

The lien creditor contended that the outcome should instead be governed by *Wolfe v. Jacobson* (*In re Jacobson*), 676 F.3d 1193 (9th Cir. 2012), handed down by the Ninth Circuit after *Owen*.

Indeed, the Ninth Circuit had said in *Jacobson* that exemptions must be determined under state law on the date of filing. However, Judge Thomas said that *Jacobson* did not concern lien avoidance. Rather, the case dealt with “a different question: whether certain funds belonged to the chapter 7 estate.”

Furthermore, Judge Thomas quoted *Owen* for saying that state law exemptions are not “absolute” but must be applied alongside competing or limiting policies in the Bankruptcy Code. *Owen, supra*, 500 U.S. at 313.

Judge Thomas said that “*Owen* resolves the matter before us,” not *Jacobson*. “[W]e must look,” she said, “to the amount of the homestead exemption that [the debtor] could have claimed if . . . the . . . lien against his property is disregarded.”

Judge Thomas therefore “arrive[d] at exactly where the bankruptcy court did.” She affirmed the bankruptcy court and allowed the debtor to avoid the judgment lien “in its entirety.”

[The opinion is](#) *Barclay v. Boskoski*, 22-55098 (9th Cir. Nov. 14, 2022).



Estate Property



If tax foreclosures violate the Takings Clause, it stands to reason that they are also fraudulent transfers.

Sixth Circuit Holds that Tax Foreclosure Violates the Takings Clause of the Constitution

The circuits are split 4/3 on the question of whether a real estate tax foreclosure can be attacked as a fraudulent transfer.

If the Sixth Circuit was correct in holding in an October 13 opinion that a tax foreclosure violated the Takings Clause of the U.S. Constitution, then it stands to reason that a tax foreclosure also can be a fraudulent transfer.

The Split

Recently, the Second Circuit joined the Third, Sixth and Seventh Circuits by holding that real estate tax foreclosures can be attacked as fraudulent transfers. To read ABI's reports, [click here](#), [here](#), [here](#) and [here](#).

Extending *BFP v. Resolution Trust*, 511 U.S. 531 (1994), the Fifth, Ninth and Tenth Circuits hold to the contrary by immunizing tax foreclosures just like mortgage foreclosures. The most recent of those decisions came from the Ninth Circuit. *See Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI's report on *Tracht Gut*, [click here](#).

The Michigan Tax Foreclosures

Homeowners sued in federal district court alleging that tax foreclosures under Michigan law violated the Takings Clause of the Fifth Amendment, which says that "private property" shall not "be taken for public use, without just compensation."

The county took title when one of the homeowners owed \$22,300 in real estate taxes. The county subsequently transferred title to a nonprofit entity that sold the home for \$308,000. Another homeowner owed \$30,500 in taxes on a home that the nonprofit sold for \$155,000 after the county had foreclosed. Neither of the homeowners received any of the proceeds.

The district court dismissed the suit, finding no violation of the Takings Clause because state law defined the homeowners as having no property interest after forfeiture.

The homeowners appealed to the Sixth Circuit.



State Law and History

Circuit Judge Raymond M. Kethledge laid out Michigan law in detail. Briefly, if real estate taxes are not paid for one year, title is forfeited, but forfeiture does not affect title. Rather, the governmental unit is entitled to petition for a “judgment of foreclosure.” Meanwhile, the homeowner is given notices and an opportunity to redeem by paying the taxes, penalties and interest.

About one year later, the state court is required to enter a judgment of foreclosure that vests absolute title if the owner has not redeemed. Thereafter, the government may sell the property at public auction, but the owner is entitled to none of the proceeds.

In the cases on appeal, Judge Kethledge said that the “County forcibly took property worth vastly more than the debts these plaintiffs owed, and failed to refund any of the difference.” Even so, was there a violation of the Takings Clause?

To answer the question, Judge Kethledge embarked on a detailed examination of foreclosure in England and the U.S. going back to the fifteenth century, going back to the notion of a “mort gage,” or dead pledge. He explained how English chancery courts took issue with the “intolerably harsh sanction” handed down by the law courts when someone defaulted and lost equity in the property.

By the seventeenth century, Judge Kethledge said that the chancery courts recognized a landowners’ equity of redemption and “resisted strict foreclosure for the same reasons they recognized the landowner’s equity of redemption.”

In the U.S., Judge Kethledge said that “American courts were uniformly hostile to strict foreclosure.” By the mid-1800s, he said that “foreclosure by sale was ‘firmly established’ in the law of most states, to the exclusion of strict foreclosure.”

The Takings Violation

Judge Kethledge said that “Michigan law flatly contravened all these long-settled principles when it allowed Oakland County to take ‘absolute title’ to the plaintiffs’ homes as payment for their tax delinquencies.” More specifically, he said that “the County took their equitable titles . . . without a public foreclosure sale and without payment to the plaintiffs for the value of those titles.”

“The County’s foreclosure of these properties was thus nothing less than a strict foreclosure — a practice that English courts had steadfastly prevented as far back as the 1600s and that American courts (not least Michigan ones) effectively eradicated as ‘unconscionable’ and



‘draconian’ some 200 years ago,” Judge Kethledge said. In addition, he said that “Michigan law fails to recognize equitable title in other contexts.”

Judge Kethledge reversed the dismissal of the homeowners’ suit because the county had forcibly taken the homes “worth vastly more than the debts these plaintiffs owed.” By taking property without “just compensation,” he said there was a violation of the Takings Clause.

Observation

Courts avoid making constitutional declarations when a case can be decided on more narrow grounds. Thus, we may not see other courts deciding the takings issue raised in the Sixth Circuit, but courts can use the Sixth Circuit’s opinion to allow fraudulent transfer attack on tax foreclosures.

[The opinion is](#) *Hall v. Meisner*, 21-1700 (6th Cir. Oct. 13, 2022.)



ause a limited partner's obligations were only 'options,' the partnership agreement was not an executory contract, Chief Judge Meier says.

Limited Partnership Agreement Is an Estate Asset, Not an Executory Contract

An individual bankrupt's interest in a limited partnership is akin to an option and isn't an executory contract subject to automatic rejection 60 days after filing, according to Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho.

On filing in chapter 7, the debtor had a 10.5% interest in a limited partnership. The partnership agreement gave the debtor the right to request distributions from the partnership to cover the debtor's tax liabilities arising from the debtor's share of partnership income. The agreement also gave other partners a right of first refusal if a partner were to sell his or her partnership interest voluntarily or involuntarily.

The trustee did not move to assume the partnership agreement within 60 days of filing in 2016. More than 60 days after filing, the trustee did request and did receive distributions from the partnership to cover taxes for the years 2017 and 2018.

For 2019, however, the partnership refused to honor the trustee's request for a tax distribution. The trustee filed a complaint in bankruptcy court seeking a declaration that the partnership interest was property of the estate and that the trustee was entitled to tax distributions.

The trustee moved for partial summary judgment to declare that the partnership interest was not an executory contract that was automatically rejected 60 days after filing under Section 365(d)(1). Naturally, the partnership took the position that it was an automatically rejected executory contract, leaving the trustee with nothing to sell.

In his February 24 opinion, Judge Meier addressed the question of whether the partnership interest was an executory contract under the so-called Countryman definition. The late Harvard Law School Professor Vern Countryman defined a contract as executory if the obligations of both parties are so far unperformed that a failure by either to complete performance would constitute a material breach excusing performance by the other.

The Right to Distributions



Employing the Countryman test, Judge Meier examined the outstanding obligations of the debtor on the filing date.

Judge Meier said that the right to receive tax distributions “is akin to an option” and that an option is the “grant of a right without any obligation.”

Judge Meier found controlling Ninth Circuit authority in *Unsecured Creditors Comm. Of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)*, 139 F.3d 702, 705 (9th Cir. 1998) (*en banc*). In *Helms*, the Ninth Circuit sat *en banc* to overrule the circuit’s prior authority, which had held that all options are executory.

Helms said that performance “due only if the optionee chooses at his discretion to exercise the option doesn’t count unless he has chosen to exercise it.” Typically, the appeals court said, the optionee has breached no material obligations “by doing nothing,” that is, by not exercising the option.

Judge Meier interpreted *Helms* to mean “that an option is non-executory if the optionee need not exercise the option, and if he does nothing, the option lapses without breach.” In the case before him, Judge Meier said that a partner’s failure to exercise the option meant that the option lapsed without breach.

Definitionally speaking, Judge Meier held that the option to take down distributions did not make the agreement executory.

The Right of First Refusal

The partnership argued that the right of first refusal made the agreement executory.

Reasoning that the failure to exercise a right of first refusal would not breach a performance obligation, Judge Meier held that the first refusal provision did not render the agreement executory.

The Partnership’s Defenses

The partnership offered several defenses, none of which persuaded Judge Meier.

Even if the partnership agreement was a personal services contract under Section 365(c), it didn’t matter because the contract was not executory.

The partnership argued for executory treatment because the state Uniform Partnership Act imposes obligations of good faith and fair dealing. Judge Meier could not “fathom” how a statutory requirement could “singlehandedly” make the contract executory. If it were so, he said, “all contracts would be executory.”



Estoppel didn't preclude the trustee's motion, Judge Meier said, because the trustee had not falsely concealed a material fact. Likewise, quasi-estoppel didn't apply because it was not unconscionable for the trustee to say the agreement was not executory when the partnership had honored distribution requests long after the 60-day window for assumption had passed.

There was no judicial estoppel because the trustee had not changed positions, and there was no waiver because the trustee had previously requested distributions.

Judge Meier granted summary judgment to the extent of declaring that the agreement was valid and enforceable to the extent that it was not executory.

"As to any other reason the Agreement may not be valid or enforceable as to the estate's interest," Judge Meier said it "would be a separate issue which is not presently before the Court." He left open the question of whether the trustee could sell, assume or assign the limited partnership interest.

Observations

Prof. Jay L. Westbrook told ABI that the "Countryman test has greatest difficulties with unilateral contracts like options because failure of the option holder to exercise is almost never a material breach, yet an option, of course, can be of great value, so any trustee would want to assume."

In his seminal article about executory contracts in 2017, Prof. Westbrook said about limited partnerships that "the material breach test rarely arrives at the right question because the analysis gets lost on the 'executoriness' detour." See Prof. Jay L. Westbrook and Kelsi S. White, "[The Demystification of Contracts in Bankruptcy](#)," 91 *Am. Bankr. L.J.* 481 (Summer 2017). Prof. Westbrook occupies the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law.

In his article, Prof. Westbrook said that "it is easy to get lost trying to determine whether LLC agreements meet the material breach test for executoriness." Citing "irreconcilable precedents," he said that "courts are currently wrestling with that question."

Under the "functional analysis" proposed in his article, Prof. Westbrook said that "this entire debate can be sidestepped because it is clear that any LLC agreement has at least some remaining obligations rendering it 'executory' under the common law definition of the word."

Using the professor's approach, a limited partnership agreement would be an executory contract if there were either obligations the trustee would wish to avoid or value that the trustee would wish to collect for creditors. In the case before Judge Meier, the partnership agreement



would be executory under Prof. Westbrook's approach because there obviously was value in the right to claim distributions and, presumably, also in selling the limited partnership interest.

Prof. Westbrook points out in his article how some courts view limited partnership agreements not as contracts but as assets to be handled under Section 541. With respect to those courts that see partnership agreements as assets, this writer would observe that partnership agreements confer contractual rights on limited partners and therefore resemble contracts. Whether those obligations are material under the Countryman test is another question.

A limited partnership is a hybrid creature not easily pigeonholed. It is akin to the ownership of stock in an ordinary corporation, in that the owner has no personal liability for the corporation's debts. On the other hand, limited partners have rights with respect to the corporation not enjoyed by ordinary stockholders.

A limited partnership interest perhaps more resembles preferred stock. Neither common nor preferred stock is rejectable. As assets that are not contracts, stock can be abandoned or sold with no 60-day limitation for assumption or rejection.

Limited partnership agreements more resemble contracts than stock. If rights and obligations have not been fully performed, why does it matter if they remain only on one side? If a right or an obligation has economic consequences to assume or avoid, why does it matter if they are unilateral?

Courts' approaches to executory contracts are evolving. In a recent opinion on surety bonds, for instance, the Fifth Circuit said that courts should not foreclose the use of the functional analysis when confronting multiparty contracts. *Argonaut Ins. Co. v. Falcon V LLC (In re Falcon V LLC)*, 44 F.4th 348, 355 at fn. 9 (5th Cir. Aug. 11, 2022). To read ABI's report, [click here](#).

The bottom line is this: If the court applies the Countryman definition, a limited partnership interest might not be an executory contract. If a court were to employ Prof. Westbrook's functional analysis, the partnership interest might be executory. Or, a partnership interest might be some peculiar sort of an asset.

Keep in mind that a court employing Prof. Westbrook's analysis could rule that a partnership interest was rejected automatically if it was not assumed in a timely manner.

Given the confusion about limited partnerships, a trustee or a debtor at the outset of a case should determine whether the partnership interest has value or whether there are onerous obligations. Even if the particular judge sitting on the case has taken a position elsewhere, the trustee should ask the court proactively to decide whether or not the partnership agreement is executory or is another sort of an asset.



The nature of a partnership interest isn't likely to be resolved soon. And limited partnership agreements are not uniform, so the result in one case might not control in another.

Consequently, a trustee should quickly decide whether to assume, reject, sell, assign or abandon a partnership interest. On the other side of the coin, the limited partnership should move for a declaration that the executory contract was automatically rejected after 60 days or to compel the debtor to abandon the asset.

[The opinion is](#) *Rainsdon v. Duncan LP (In re Duncan)*, 20-8056 (Bankr. D. Idaho Feb. 24, 2023).



Unlike Clark v. Rameker, where an inherited IRA wasn't exempt, the inheritance of benefits under a pension plan might not become estate property under Section 541(c)(2).

Survivor's Benefits Under a Pension Plan Might Not Become Estate Property

Although the Supreme Court held in *Clark v. Rameker*, 573 U.S. 122 (2014), that an inherited individual retirement account is not exempt, the inheritance of survivor's benefits under a pension plan can be excluded from a debtor's bankrupt estate, for reasons explained by Bankruptcy Judge David T. Thuma of Albuquerque, N.M.

In his February 10 opinion, Judge Thuma wasn't required to decide whether the debtor's survivor's benefit was exempt.

The debtor's father worked for the City of New York for three decades and was the beneficiary of a defined-benefit pension plan under the city's retirement system. Upon retirement, the father elected to receive smaller benefits in return for survivor's benefits for his son. When his father died in 2013, the son applied for and began receiving survivor's benefits of about \$1,100 a month.

The son filed a chapter 7 petition in 2021 and claimed that his survivor's benefits were exempt under Section 522(b)(3)(C). He also asserted that the benefits were not estate property.

The trustee objected to the exemption claim. Judge Thuma described the trustee as arguing that the "Debtor's inherited interest in the [pension] Plan is comparable to the inherited IRA in *Clark*, should not be considered a retirement fund under § 522(b)(3)(C), and therefore is not exempt."

Judge Thuma never ruled on the exemption claim because he found that the survivor's benefits were not taken into estate property. He focused instead on Section 541(c)(2), which provides that a "restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title." In other words, valid spendthrift trusts do not become estate property.

The word "trust" not defined in the Bankruptcy Code, Judge Thuma recited the four elements required under New York law for the validity of a trust. He found that all were present in the father's retirement plan. In addition, he cited another provision in New York law stating that the benefits under the retirement plan were not subject to execution or garnishment.



Judge Thuma therefore held “that Debtor’s interest in the [pension] Plan comes within the § 541(c)(2) exclusion and did not become part of Debtor’s bankruptcy estate when he filed this case.” Having found that the debtor’s survivor’s benefits were not estate property, he had no reason to rule on whether the benefits were also exempt under Section 522(b)(3)(C). That section exempts certain types of retirement funds that are exempt from taxation under specified provisions in the IRS Code.

A Bigger Exclusion under *Patterson v. Shumate*?

Because Judge Thuma found that the father’s pension plan came from a trust, he stopped short of ruling in the debtor’s favor under the Supreme Court’s decision in *Patterson v. Shumate*, 504, U.S. 753 (1992).

Section 541(c)(2) excludes property from the bankrupt estate if it is subject to a “restriction on the transfer of a beneficial interest of the debtor *in a trust* that is enforceable under applicable nonbankruptcy law” [Emphasis added.] Note that the section refers only to a trust and not to a pension plan.

Judge Thuma quoted the unanimous Court in *Patterson* for saying that “[t]he natural reading of [Section 541(c)(2)] entitles a debtor to exclude from property of the estate any interest *in a plan or trust* that contains a transfer restriction enforceable under any relevant nonbankruptcy law.” *Id.* at 578. [Emphasis added.]

Given the Court’s reference to “a plan or trust,” Judge Thuma said that “some courts have held that *Patterson* expanded the definition of trust beyond a literal reading or, at least, focused on the substance of the legal arrangement rather than its label.” He cited the Third Circuit for saying that *Patterson*’s language “could be interpreted to mean that § 541(c)(2) is not limited to literal trusts or trusts formed explicitly.” *In re Laher*, 496 F.3d 279, 287 (3d Cir. 2007).

Because Judge Thuma found that the father’s pension plan came from a trust under New York law, he had no need to decide whether *Patterson* would have allowed him to employ a more expansive definition of “trust.

[The opinion is](#) *In re Piskiel*, 21-10717 (Bankr. D.N.M. Feb. 10, 2023).



In Section 522(b)(3), Congress made sure that ‘retirement funds’ are exempt in bankruptcy even if they aren’t exempt in states that don’t permit federal exemptions.

***Clark v. Rameker* Didn’t Say that All Inherited IRAs Aren’t Exempt**

The Supreme Court’s decision in *Clark v. Rameker*, 573 U.S. 122 (2014), does *not* mean that all inherited IRAs are *not* exempt. As explained by Chief Bankruptcy Judge Thad J. Collins of Cedar Rapids, Iowa, some inherited IRAs can be exempt.

Specifically, a surviving spouse is entitled to exempt an inherited IRA if the surviving spouse elects to roll over the inherited IRA into a traditional IRA or a Roth IRA.

No State Exemption for the Inherited IRA

The debtor’s husband died in 2008. The debtor at that time rolled over her deceased husband’s IRA into her own IRA. She had contributed nothing to her husband’s IRA. Her husband or his employer made all of the contributions.

The surviving wife filed a chapter 7 petition in 2022 and claimed an exemption in the inherited IRA. The trustee objected, citing *Clark* and saying that an inherited IRA is not exempt under Iowa law.

Judge Collins overruled the objection and allowed the exemption in an opinion on April 11.

The Federal Exemption Applied

Iowa only allows its bankrupt citizens to take state exemptions. The debtor therefore could not claim an exemption for “retirement funds” in Section 522(d)(11). Under Iowa law, inherited IRAs are not exempt, seeming to leave the debtor with no ability to retain the inherited IRA.

No so, Judge Collins said, citing Section 522(b)(1) and (b)(3).

With federal exemptions unavailable, Judge Collins said that the debtor was limited to exemptions provided in Section 522(b)(3). Subsection (b)(3)(C) allows exemptions for “retirement funds” that are exempt from taxation under specified provisions of the IRS Code.



Judge Collins cited and quoted *In re Pacheco*, 537 B.R. 935, 939 (Bankr. D. Ariz. 2015), where Chief Bankruptcy Judge Eddward P. Ballinger, Jr., said,

The exemption under § 522(b)(3)(C) is available to all debtors regardless of whether the debtor’s particular state has opted out of the federal exemption scheme of § 522(d) The addition of 522(b)(3)(C) was intended to expand the protection granted to retirement plans in bankruptcy that may not have been already protected under state or federal law.

Next, Judge Collins analyzed whether the inherited IRA qualified as “retirement funds” under Section 522(b)(3)(C).

In *Clark*, the Supreme Court held that inherited IRAs are not exempt. Judge Collins explained that the opinion gave the surviving spouse an election between (1) rolling over the inherited IRA subject to tax and bankruptcy rules for traditional IRAs or Roth IRAs, or (2) keeping the inherited IRA as an inherited IRA subject to different tax and bankruptcy rules for inherited IRAs.

In the case at hand, Judge Collins said that the debtor had rolled over the inherited IRA into the IRA she claimed as exempt. As a consequence, he said that the “Debtor’s IRAs are retirement accounts . . . [that] are subject to the same tax and bankruptcy rules as would apply to funds that Debtor had contributed herself.”

Judge Collins held that the “Debtor therefore properly claimed exemption of the funds in her IRAs.”

Observations

Someone with an IRA inherited from a deceased spouse may be better off in bankruptcy than not in bankruptcy. In Iowa, for instance, the rolled-over IRA would not be exempt for someone not in bankruptcy.

We have been told that some other states amended their exemptions after *Clark* to cover inherited IRAs.

Counsel in states that don’t exempt inherited IRAs should consider lobbying the legislature to expand the exemption to cover inherited IRAs, especially because the prospect of losing an inherited IRA could force a surviving spouse into an otherwise unnecessary bankruptcy.

[The opinion is](#) *In re Kelly*, 22-00089 (Bankr. N.D. Iowa April 11, 2023).



Subordinated lenders can't take a 'haircut,' give a 'tip' to the trustee, sell a home and eradicate the debtor's homestead exemption.

Another Court Won't Permit a Structured Sale to Eradicate a Homestead Exemption

Employing the most vituperative language employed so far to nix the strategy, a district judge in North Carolina affirmed Bankruptcy Judge Laura T. Beyer, who had barred secured creditors from taking haircuts so the trustee could pay his commission and make a small distribution to general creditors while cheating the debtor out of her homestead exemption.

In his March 13 opinion, Statesville, N.C.'s District Judge Kenneth D. Bell called the proposal a "backroom deal," a "sham" and a "bastardization of the bankruptcy process."

The chapter 7 debtor was a 72-year-old widow whose only source of income was Social Security benefits. She owned a home with a scheduled value of \$125,500 and claimed a \$55,000 homestead exemption under North Carolina law.

The home was subject to a \$52,700 first mortgage. The IRS had a valid tax lien on the house for \$113,000 alongside a valid state tax lien of almost \$48,000. The total encumbrances were almost \$214,000.

The trustee believed the house was actually worth \$180,000 and wanted to sell. Regardless of the actual value of the house, Judge Bell said there was no equity in the home above the secured indebtedness. Under the circumstances, "This would typically prevent a sale of the Property," he said.

The trustee hatched a deal with the IRS and the state taxing authority. (Note: The tax liens likely would be wiped out in foreclosure by the holder of the first mortgage.)

The IRS and the state taxing authority agreed to a 40% "haircut" on their liens, generating about \$68,000 for the trustee. The trustee would use the leftover first to pay administrative expenses and his commission, totaling some \$30,000.

From the \$38,000 remainder of the carveout, \$33,000 would go to the taxing authorities on their priority claims, leaving \$5,000 for general unsecured creditors and \$2,000 for the debtor. (Remember, her state home exemption was \$55,000.)



Judge Bell said that deal would have left the debtor with “no meaningful source of income” and no home in which to live.

The trustee filed an objection to the debtor’s homestead exemption together with a motion to sell the property and implement the deal with the taxing authorities. Bankruptcy Judge Beyer denied the motion. The trustee appealed.

The trustee argued that the deal was kosher under Section 724(b), the complex provision in the Bankruptcy Code dealing with distribution of the proceeds from the sale of encumbered property when a trustee has been appointed. Basically, the section subordinates tax liens to the payment of the trustee’s administrative expenses.

Under Section 724(b), sale proceeds go to (1) the mortgage holder, (2) administrative creditors (*i.e.*, the trustee), (3) holders of tax liens to the extent their liens exceeded administrative expenses, (4) the unpaid portion of tax liens, and (5) the estate.

Judge Bell said that Section 724(b) “allows for encumbered property to be sold.” (Respectfully, it does not. Section 365 authorizes sales. Section 724 allocates the distribution from proceeds of authorized sales.)

“Conspicuously absent from § 724(b)’s distribution scheme is any mention of exemptions,” Judge Bell said. As a result, courts have reached “inconsistent results for varying rationales.”

In North Carolina, exemptions are construed “liberally with an eye in favor of exemptions,” Judge Bell said. With “liberal construction in mind,” he found that “the carved-out funds are subject to the Debtor’s homestead exemption.” He said that the “Trustee and tax agencies cannot defeat the Debtor’s homestead exemption by agreement absent any authority from the Code or North Carolina law.”

“Put another way, once the tax agencies agree to the carve-out they cannot direct the allocation of the value created by such carve-out,” Judge Bell said.

Judge Bell found support in *Law v. Siegel*, 571 U.S. 415 (2014), where the Supreme Court held that exemptions can be denied only for reasons set forth in the Bankruptcy Code or state law. In the appeal before him, he said that the trustee wanted “to deprive the Debtor of her homestead exemption on a basis that is not enumerated in the Code or North Carolina law.”

“Even more to the point,” Judge Bell said, “the Trustee’s Motion must be denied because it substantially benefits no one other than himself and the tax agencies.” Citing a district judge in his own district, he said that “property may not be sold solely to benefit secured creditors or the Trustee.”



Affirming Bankruptcy Judge Beyer, Judge Bell said that the deal was “not intended to benefit the general unsecured creditors but it was concocted to allow the tax agencies to ‘tip’ the Trustee for selling the Debtor’s home.”

[The opinion is](#) *Summerlin v. Turnage*, 22-00122 (W.D.N.C. March 14, 2023).



Splitting with the Tenth Circuit, the Ninth Circuit holds that chapter 13 debtors lose post-petition appreciation in a home if the case converts to chapter 7.

Circuits Are Now Split on Who Gets Appreciation in a Home When a '13' Converts to '7'

Splitting with the Tenth Circuit, a divided panel on the Ninth Circuit held that the post-petition appreciation in the value of a home belongs to creditors when a chapter 13 debtor converts the case to chapter 7.

The dissenter on the Ninth Circuit said that the majority “effectively punishes the [debtors] for filing under Chapter 13 with the forced sale of their home. Because that outcome is not the best reading of the Bankruptcy Code or our precedents,” the dissenter said he would have held, “consistent with the Tenth Circuit, that postpetition, preconversion appreciation belongs to the [debtors] rather than the converted Chapter 7 estate.”

Forced to Sell the Home

Eighteen months after confirming a chapter 13 plan, a couple were forced to convert their case to chapter 7 because the husband developed Parkinson’s Disease and could no longer work.

In the chapter 13 case, the debtors had scheduled their home as being worth \$500,000. There was no equity in the home given the \$375,000 mortgage and the debtor’s claimed homestead exemption of \$125,000.

After conversion, the chapter 7 trustee alleged that the property was worth \$700,000 and filed a motion for authority to sell the home. The debtors argued that the valuation at conversion didn’t matter because appreciation during chapter 13 belonged to them.

Bankruptcy Judge Marc Barreca of Seattle disagreed with the debtors and held that post-petition, pre-conversion appreciation belongs to the chapter 7 estate. *In re Castleman*, 631 B.R. 914 (Bankr. W.D. Wash. June 4, 2021). To read ABI’s report, [click here](#).

The debtors appealed and lost again in district court. *In re Castleman*, 21-00829, 2022 BL 229708, 2022 US Dist. Lexis 116941, 2022 WL 2392058 (W.D. Wash. July 1, 2022). To read ABI’s report, [click here](#). The debtors appealed to the circuit.

The Majority Opinion



For the majority, Circuit Judge Michael D. Hawkins said that the courts are “heavily divided.” He cited the Tenth Circuit for holding that post-petition appreciation in a nonexempt asset belongs to the debtor on conversion from chapter 13 to chapter 7. *See In re Barrera*, 22 F.4th 1217 (10th Cir. 2022). To read ABI’s report, [click here](#). However, he did not cite his own Ninth Circuit Bankruptcy Appellate Panel for reaching the same result as the Tenth Circuit by giving appreciation to the debtor. *See Black v. Leavitt (In re Black)*, 609 B.R. 518 (B.A.P. 9th Cir. Dec. 31, 2019). To read ABI’s report, [click here](#).

Among the courts bestowing appreciation on creditors, Judge Hawkins cited the bankruptcy court’s opinion in *In re Goetz*, 647 B.R. 412 (Bankr. W.D. Mo. Nov. 10, 2022). To read ABI’s report, [click here](#). [Note: Judge Hawkins did not cite the Eighth Circuit Bankruptcy Appellate Panel’s affirmance in *Goetz v. Weber (In re Goetz)*, 651 B.R. 292 (B.A.P. 8th Cir. June 1, 2023). To read ABI’s report, [click here](#). Note also that *Goetz* is on appeal to the Eighth Circuit.]

Several statutes are in play. Section 348(f)(1), which underwent substantial amendment in 1994, provides that “property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.”

The amendment was intended to overrule caselaw holding that property obtained after filing a chapter 13 petition becomes estate property once the case converts to chapter 7.

Primarily relied on by the majority, Section 541(a)(6) provides that estate property includes “[p]roceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.”

Citing *In re Goins*, 539 B.R. 510, 516 (Bankr. E.D. Va. 2015), Judge Hawkins said that the equity is “inseparable” from the real estate. Citing previous Ninth Circuit opinions and Section 541(a)(6), he said that post-petition appreciation in real estate belongs to the estate, not the debtor. *Schwaber v. Reed (In re Reed)*, 940 F.2d 1317, 1323 (9th Cir. 1991); and *Wilson v. Rigby*, 909 F.3d 306, 309 (9th Cir. 2018). [Note: Judge Hawkins did not mention that the two Ninth Circuit opinions dealt with cases in chapter 7, not conversions from chapter 13.]

Although the two opinions were chapter 7 cases, Judge Hawkins found “no textual support for concluding that § 541(a) has a different meaning upon conversion from Chapter 13.”

Judge Hawkins said that “many” cases reached a different conclusion by reference to the legislative history surrounding the 1994 amendment to Section 348(f). Those courts read the amendment’s legislative history as saying that appreciation after filing in chapter 13 belongs to the debtor.



Judge Hawkins did “not look to legislative history for guidance” because he concluded that the statute was not ambiguous.

Citing the Tenth Circuit’s *Barrera* decision, Judge Hawkins said that “some” courts give appreciation to the debtor by relying on Section 1327(b), the statute that reverts estate property in the debtor on chapter 13 confirmation. However, he said that “§ 348(f) only clarified that newly acquired, post-petition property would not become part of the converted estate.”

“In sum,” Judge Hawkins said, “the plain language of § 348(f)(1) dictates that any property of the estate at the time of the original filing that is still in [the] debtor’s possession at the time of conversion once again becomes part of the bankruptcy estate, and our case law dictates that any change in the value of such an asset is also part of that estate. In this case, that property increased in value.”

In a footnote after affirming the lower court’s holding that appreciation enhanced the chapter 7 estate, Judge Hawkins said that the decision did not resolve the debtors’ argument to have an administrative claim for payments they made on the mortgage after confirmation of the chapter 13 plan.

The Dissent

Circuit Judge Richard C. Tallman opened his dissenting opinion by saying that the majority created “a circuit split and effectively punishes the [debtors] for filing under Chapter 13 with the forced sale of their home.” As a result, he said that “the majority sacrifices the text of the bankruptcy statutes on the altar of simplicity.”

Judge Tallman characterized the majority as reaching a “simple resolution” by holding that appreciation in chapter 13 goes to the estate “because we have held [that] appreciation becomes part of the estate in a Chapter 7 case.”

“But simplicity,” Judge Tallman said, “cannot take precedence over the text of the Bankruptcy Code, and if we read § 348(f) in light of the Code ‘as a whole’ — rather than just § 541(a) — [*Wilson v. Rigby*] is not dispositive.” The “remainder” of the Bankruptcy Code, he said, “clarifies” that “property of the estate” is defined differently in chapter 13 than it is in chapter 7.

In view of Section 1327(b), Judge Tallman said that the debtor once again becomes the owner of the home on confirmation. “It follows,” he said, “that when a Chapter 13 plan has been confirmed, appreciation accrues to the debtor.”

Judge Tallman quoted the decision by “our Bankruptcy Appellate Panel” in *Black* for “holding that ‘the reversioning provision of the confirmed plan means that the debtor owns the property outright



and that the debtor is entitled to any postpetition appreciation.” *Black, supra*, 609 B.R. at 529. The Tenth Circuit, he said, “reached a similar conclusion” in *Barrera*.

Judge Tallman went on to cite *Barrera* for holding that Section 541(a)(6) is only operative before confirmation because confirmation reverts property in the debtor. He then quoted the Tenth Circuit for saying that proceeds generated from property after confirmation do not become estate property.

Consistent with the Tenth Circuit, Judge Tallman said that he “would hold . . . that postpetition, preconversion appreciation belongs to the [debtors] rather than the converted Chapter 7 estate.”

On top of the majority’s erroneous interpretation of the statute, Judge Tallman said that “the majority’s reading of § 348(f)(1)(A) is also inconsistent with the statute’s structure, object, policies, and legislative history.” Citing the legislative history accompanying the adoption of Section 348(f)(1)(A) in 1994, he said, “Clearly, Congress believed that home equity which accrued during Chapter 13 proceedings should not be included in the converted estate.”

Where the majority declined to take guidance from legislative history, Judge Tallman said it was “consistent with the text of the Bankruptcy Code, directly relevant to the case at hand, and unequivocally confirms that appreciation in the value of the [debtors’] home should not become part of the converted estate.”

To this writer, Judge Tallman cast his reading of the statute in terms of fairness. Had the debtors originally filed in chapter 7, he said that all of their home equity would have been exempt. By having taken a shot at chapter 13, he said they were left in a “worse position,” which he called “the situation Congress sought to prevent.”

Although he recommended that Congress once again amend Section 348(f) “to make the answer clear,” Judge Tallman said he “would hold that the appreciation belongs to the [debtors].”

The opinion is *Castleman v. Burman (In re Castleman)*, 22-35604 (9th Cir. July 28, 2023).



In a rising real estate market, chapter 13 debtors risk losing their homes if they sell or convert to chapter 7.

BAP Gives Post-Petition Appreciation to Chapter 7 Estate on Conversion from Chapter 13

Taking sides on a question where the courts are split, the Bankruptcy Appellate Panel for the Eighth Circuit puts chapter 13 debtors at risk of losing their homes if the price of real estate has risen and the debtors sell their homes or convert their cases to chapter 7.

Unless the case goes to the Eighth Circuit and the Court of Appeals reads the statute differently, chapter 13 debtors need to remain in their homes until they have completed plan payments and received their discharges, and the cases have been closed.

Pity the debtor who is forced to sell her home, perhaps to take a job in another city or because of divorce. By losing the equity above the homestead exemption, the debtor may not be able to purchase a comparable home elsewhere.

Affirming Chief Bankruptcy Judge Brian T. Fenimore of Kansas City, Mo., the BAP held on June 1 that the post-petition appreciation in the value of a home belongs to creditors if the case converts to chapter 7.

Typical Facts

The debtor filed a chapter 13 petition and confirmed a plan. She scheduled her home as worth \$130,000 and claimed a \$15,000 homestead exemption. The home had a \$107,000 mortgage. Everyone agreed that the estate would have received nothing had the home been sold on the filing date. In other words, the debtor was *not* buying back the equity in her home through the plan. The home reverted in the debtor on confirmation.

The debtor converted her case to chapter 7 about two years after filing. The parties agreed that the home had increased \$75,000 in value during the chapter 13 case. While in chapter 13, the debtor had reduced the mortgage by almost \$1,000. After paying the mortgage and the debtor's \$15,000 homestead exemption, the trustee was laying claim to some \$62,000.

To stop the chapter 7 trustee from selling the home, the debtor filed a motion to compel the trustee to abandon the home under Section 554. The debtor contended that the home still had inconsequential value for the chapter 7 estate because the equity above the mortgage and the



exemption were fixed as of the chapter 13 filing date when there was no objection to the claimed exemption.

In November, Judge Fenimore denied the debtor’s motion to compel abandonment. *In re Goetz*, 647 B.R. 412 (Bankr. W.D. Mo. Nov. 10, 2022). To read ABI’s report, [click here](#). The debtor appealed, but the BAP affirmed, in an opinion by Bankruptcy Judge Shon Hastings.

The Debtor’s Theories

The debtor had several theories underpinning her claimed right to retain post-petition appreciation. She wasn’t alone: The National Association of Consumer Bankruptcy Attorneys and the National Consumer Bankruptcy Rights Center submitted a brief in support of the debtor.

The debtor theorized that she retained all of the equity because the home had reverted in her on confirmation and the increased equity did not exist on filing. The debtor and the *amici* urged the panel to rely on legislative history in connection with the amendment to Section 348(f)(1)(A). They also argued that turning the appreciation over to the trustee would treat the debtor as though she had converted the case in bad faith.

None of the arguments persuaded the panel.

The Split

Two statutory provisions come into play. Neither is on point.

When a chapter 13 case converts to a case under another chapter, Section 348(f)(1)(A) provides that “property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.” The section does not say who gets appreciation in property between the filing date and the date of conversion.

More expansively, Section 541(a) provides that estate property includes “(6) Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case” and “(7) Any interest in property that the estate acquires after the commencement of the case.”

Judge Hastings said that the “courts are split on the question of whether postpetition preconversion market appreciation or an increase in equity resulting from payments toward a lien inures to a debtor’s benefit upon conversion to a Chapter 7 case.”



“Some courts,” Judge Hastings said, believe that post-petition appreciation is new property carved out of the converted estate by Section 348(f)(1)(A). Others use “a slightly different rationale” by focusing on legislative history and policy to say that taking away appreciation penalizes a debtor for making a stab at chapter 13.

Courts taking away appreciation, Judge Hastings said, do not see the new value as a separate asset acquired after filing but as a constituent part of the home on the filing date.

Plain Meaning Carries the Day

For Judge Hastings, the “plain meaning of a statute is conclusive.” She declined to assume that Congress amended Section 548(f) to mean that debtors may retain “postpetition preconversion market appreciation” because there was no “language articulating this intent.” She therefore held that “the bankruptcy court correctly concluded that postpetition preconversion nonexempt equity accrues for the benefit of the converted Chapter 7 estate.”

Judge Hastings also dismissed the idea that revesting on confirmation took the home and its appreciation out of the estate. She said that “neither section 1327(b) nor the relevant provision of the confirmation order applies in the converted Chapter 7 case.”

“Rather,” Judge Hastings said, Section 348 “governs the scope of estate property upon conversion.”

Reliance on the state’s exemption statute was likewise of no avail. The exemption did not take the entire home out of the estate, only \$15,000.

Finally, Judge Hastings was influenced by the use of present-tense verbs in Section 544(b), governing abandonment. Because the statute refers to property that “is burdensome” or “is of inconsequential value,” the idea that the “homestead exemption claim limited the estate’s interest in her residence to its value on the petition date is not persuasive.”

Holding that “the postpetition preconversion equity increase in [the debtor’s] residence is property of the bankruptcy estate,” Judge Hastings upheld denial of the motion aiming to compel the trustee to abandon the home.

Questions

Assume that Section 348(f)(1)(A) does not exclude appreciation from the chapter 7 estate:

- (1) Wasn’t the homestead exemption final when no one objected early in the chapter 13 case? What authority allows the chapter 7 trustee or a creditor to reopen final exemptions?



- (2) Why limit the revaluation of homes to situations where the case converts or the debtor sells the home?
- (3) Real estate prices have risen dramatically throughout the country in the last three years. Why not routinely revalue homes throughout chapter 13 cases?
- (4) Why not revalue all other estate property continually until the chapter 13 debtor receives a discharge and the case is closed?

The opinion is *Goetz v. Weber (In re Goetz)*, 22-6009 (B.A.P. 8th Cir. June 1, 2023).



Courts are deeply split on a chapter 13 debtor's ability to keep the appreciation in an exempt home, whether or not the case converts to chapter 7.

Post-Petition Appreciation in the Value of a Home Goes to Creditors in Chapter 13

On an issue where the courts are widely divided, Chief Bankruptcy Judge Brian T. Fenimore of Kansas City, Mo., adopted the so-called estate-replenishment theory to conclude that appreciation in a home sold after confirmation of a chapter 13 plan belongs to creditors.

Judge Fenimore's January 17 opinion is an admirable summary of the pros and cons of the five competing theories to decide whether post-confirmation proceeds are or are not property of the chapter 13 estate.

The Post-Confirmation Sale

A couple filed a chapter 13 petition owning a home they listed as having a value of \$140,000. The home was subject to a mortgage of almost \$125,000. The exemption was \$15,000. Evidently, there were no objections to the homestead exemption or any disagreement about the value of the home.

The debtors' income was below median, but they elected to confirm a five-year plan. The debtors paid the mortgage through the trustee, while unsecured creditors were to receive nothing. The plan revested estate property in the debtors on confirmation.

More than three years after filing but before the end of the five-year term of the plan, the debtors filed a motion to sell the home for \$210,000. The court approved the sale, which generated net proceeds of about \$73,000. The mortgage payoff apparently left nothing else to pay under the plan.

The debtors filed a motion to retain the net proceeds from the sale. The chapter 13 trustee objected, asking Judge Fenimore to rule that the debtors must turn over enough to pay 100% of unsecured creditors' claims.

The debtors took the position that the home and its proceeds were not estate property because Section 1327(b) revested the home and the proceeds in them on confirmation.

The Competing Code Sections



Judge Fenimore saw a “conflict” among Sections 541, 1306 and 1327.

The home itself was estate property on filing under Section 541(a), and proceeds of estate property become estate property under Section 541(a)(6).

Section 1306(a)(1) says that property of the estate in chapter 13 includes property of the type in Section 541 “that the debtor acquires” after filing but before the case is closed.

Section 1327(b) provides that “the confirmation of a plan vests all of the property of the estate in the debtor,” unless the plan or the confirmation order provides otherwise.

On one hand, Judge Fenimore said that Sections 541 and 1306 “appear to capture” property for the estate that the debtor owned before and after confirmation. Those two sections taken in isolation would seem to take sale proceeds into the estate.

On the other hand, Judge Fenimore said that “§ 1327 arguably alters the estate’s interest in property at the moment the court confirms the debtor’s chapter 13 plan.”

“Some courts,” Judge Fenimore said, believe that Section 1327 takes property out of the estate and into the control of the debtor after confirmation.

Implications for Chapter 13 Cases

Judge Fenimore pointed out several instances where the resolution of the conflict affects chapter 13 debtors. First, the applicability of the automatic stay could turn on whether property remained under the umbrella of estate property. Second, the ability to assert an administrative claim for preservation of estate property could depend on which statute applies.

Third, resolution of the ambiguity controls the outcome in a case like that before Judge Fenimore. He exhaustively analyzed the five approaches to reconcile Sections 1306 and 1327.

The Five Approaches

Under the estate-termination approach, estate property is taken out of the estate and reverts in the debtor on confirmation. The Eighth Circuit, he said, had rejected that approach.

The estate-preservation theory means that property acquired after confirmation becomes estate property. Judge Fenimore rejected the theory for “not recognizing the import” of Section 1327.



The conditional-vesting approach means that property is both estate property and property of the debtor until completion of the plan. Judge Fenimore said that the approach creates “uncertainty.” He rejected the theory for having the “same flaws” as estate preservation.

The estate-transformation approach posits that the estate includes the income and property required to effectuate the plan. Judge Fenimore rejected the idea as having no textual basis.

Judge Fenimore adopted the estate-replenishment approach, which, he said, “reconciles” Sections 1306 and 1327.

The replenishment theory works like this: Property acquired after confirmation is not subject to Section 1327(b) because it was not in existence on confirmation. After confirmation, Section 1306(a) takes after-acquired property into the estate.

Despite what he called “flaws” and “valid critiques,” Judge Fenimore said that “the estate replenishment approach best reconciles § 1306 and § 1327.”

Applying the Facts to the Replenishment Theory

Applying the replenishment theory to the proceeds from a sale after confirmation, Judge Fenimore held that sale proceeds were estate property because they were “distinct from the property sold to produce them” and were “of the kind” specified in Section 541.

Judge Fenimore said that courts “disagree about whether proceeds from the sale of vested property are distinct from the property sold.” Some courts, he said, believe that proceeds are distinct, while others hold that “the proceeds from the later sale of that property cannot become property of the estate” because “the debtor owns vested property outright.”

Judge Fenimore conceded that unrealized appreciation cannot be divorced from property and thus remain vested in the debtor. By contrast, he said that “treating proceeds as separate property logically results from the differences between sale proceeds and unrealized appreciation.” He deduced that cash proceeds are “entirely separate from the underlying property.”

Judge Fenimore therefore held that proceeds were “a separate, distinct form of property” that “could not have vested” in the debtors on confirmation. Since the proceeds were “of the kind” specified in Section 541, he ruled that the proceeds became estate property.

Even if the proceeds were estate property, the debtors argued that they could retain the proceeds because their three-year commitment period had ended. In sum, Judge Fenimore said that the three-year period did not apply because the debtors had elected to have a five-year plan.

Postscript



Although Judge Fenimore held that the sale proceeds were estate property earmarked for creditors, he did not tell the debtors how much to turn over, because the record was insufficient.

In the days following his January 17 opinion, the debtors and the trustee settled, allowing the debtors to retain some \$62,700 while turning over about \$10,300 to the trustee.

In negotiating the settlement, the debtors may have said they were entitled to a credit for interest or principal they paid to the lender after filing. The \$10,300 may have reflected the amount in unsecured claims.

Note: Siding with what he called the “slight minority,” Judge Fenimore recently held that the appreciation in the value of a homestead during a chapter 13 case belongs to the chapter 7 estate when the case converts. *In re Goetz*, 20-41493, 2022 BL 404129, 2022 Bankr. Lexis 3188 (Bankr. W.D. Mo. Nov. 10, 2022). To read ABI’s report, [click here](#). The decision in *Goetz* is on appeal to the Bankruptcy Appellate Panel for the Eighth Circuit.

Observations

One cannot understate the importance of the issue and the eventual outcome of the split among the courts, which has begun reaching the circuits. Debtors who are unable to retain proceeds may be unable to buy another home or one equivalent to the one they are selling in chapter 13.

If proceeds belong to creditors, some debtors may be effectively precluded from selling their homes until the chapter 13 case is over. In some situations, selling a home isn’t discretionary, because the debtor may need to move for a new job.

The issue is similar to when a chapter 13 debtor sells a home in a case converted to chapter 7.

There are a pair of arguments that the debtors did not raise in the litigation before Judge Fenimore that might persuade another court to rule differently.

First, debtors can argue that creditors are not entitled to proceeds from an exempt homestead if there was no objection to the exemption and the deadline for exemption was more than one year earlier. For a decision appearing to mean that an effort to glom sale proceeds would be a collateral attack on an exemption that was final, *see Masingale v. Muding (In re Masingale)*, 644 B.R. 530 (B.A.P. 9th Cir. Nov. 2, 2022). To read ABI’s report, [click here](#).

Second, debtors could get more mileage from Section 541(a)(6), which says, “Proceeds . . . of or from property of the estate” become estate property.



In a chapter 13 case where estate property has reverted on confirmation, the words “of the estate” could be read to mean that proceeds do not become estate property because the proceeds were not derived from estate property that reverted on confirmation. Section 1306(a) would not bring proceeds into the estate because the proceeds were arguably not “of the kind specified” in Section 541.

Courts need to develop a uniform rule, given that some chapter 13 plans do not revert property in the debtor to retain the applicability of the automatic stay. The outcome also should be uniform whether or not the case converts to chapter 7.

[The opinion is](#) *In re Marsh*, 18-42471 (Bankr. W.D. Mo. Jan. 17, 2023).



Judge Rosania answered a question left open by the Tenth Circuit in Barrera.

Debtor Retains Appreciation in Nonexempt Property Sold During Chapter 13

Answering a question left open by the Tenth Circuit in *Rodriguez v. Barrera (In re Barrera)*, 22 F.4th 1217 (10th Cir. Jan. 19, 2022), Bankruptcy Judge Joseph G. Rosania, Jr., of Denver decided that a chapter 13 debtor retains appreciation in the value of nonexempt property that the debtor owned on the filing date but sold in the course of the chapter 13 case.

In *Barrera*, the Tenth Circuit held that nonexempt appreciation in the value of a home sold after confirmation of a chapter 13 plan belongs to the debtor, not to creditors, if the case converts to chapter 7 after the sale. The appeals court specifically declined to opine on the result if the debtors were to remain in chapter 13 after the sale. To read ABI's report on *Barrera*, [click here](#).

A couple confirmed a chapter 13 plan, after disputes with the chapter 13 trustee concerning the value of a limited liability corporation in which the husband owned a 13% interest. The LLC was the owner of a small office building in which the husband maintained his office.

To confirm the plan, the debtors obtained a valuation of the husband's interest in the LLC from a chapter 7 panel trustee. The panel trustee opined that the interest was worth \$15,000. The couple confirmed their five-year plan based on the \$15,000 valuation.

Three years into the plan, the other owners of the LLC decided to sell the office building. The sale resulted in net proceeds to the husband-debtor of about \$75,000. The chapter 13 trustee filed a motion aiming to compel the debtors to turn over the sale proceeds and to modify the plan.

The debtors objected and won. Judge Rosania allowed the debtors to retain the sale proceeds in his August 23 opinion.

The case called for Judge Rosania to find the answer in what he called the "apparent contradiction" between Sections 1325(a)(4) and 1306.

In addition to property in Section 541, Section 1306 says that property of the estate in chapter 13 includes property of the type in Section 541 "that the debtor acquires" after filing but before the case is closed.



Section 1325(a)(4) requires the plan to provide value to creditors, as of the effective date of the plan, that is “not less” than what would be paid “if the estate of the debtor were liquidated in Chapter 7 . . . on such date.”

In addition, Section 1327(b) provides that “the confirmation of a plan vests all of the property of the estate in the debtor,” unless the plan or the confirmation order provides otherwise.

Judge Rosania framed the question as whether the proceeds from the sale of prepetition property “should be contributed to the chapter 13 plan.” Under the “estate termination theory” espoused by other bankruptcy judges in Colorado, he said that “property vested with the debtors upon confirmation was no longer property of the estate.”

Other courts, Judge Rosania said, adopted the “estate replenishment theory” where the estate “refills” with property acquired after confirmation without regard to whether the property is necessary to perform the plan. The replenishment theory, he said, requires “continued revaluation of estate property throughout the term of the plan.”

To resolve the contradiction in the statute that the Tenth Circuit recognized in *Barrera*, Judge Rosania “determined [that] the reversion requirement under 11 U.S.C. § 1327(b) is more specific than the general language of 11 U.S.C. § 1306(a)(1)” and that “the estate termination theory gives meaning to both statutes.”

To rule in favor of the debtor, Judge Rosania observed that the sale proceeds were generated from the sale of a business entity and were not earnings under Section 1306(a)(2).

Of greater significance, perhaps, he said that the value of the interest in the LLC “was appropriately disclosed and reconciled in the best-interest-of-creditors test” and “revested with the Debtors upon confirmation.”

Judge Rosania held that the “estate termination theory . . . allows the Debtors to retain proceeds from the post-confirmation sale of prepetition property under the facts and circumstances of this case.”

[The opinion is](#) *In re Klein*, 17-19106 (Bankr. D. Colo. Aug. 23, 2022).



Rather than invoking the best interests and disposable income tests for plan confirmation, the Eleventh Circuit may have departed from the statute by ruling that the 'ability to pay' gives postpetition tort claims to creditors in chapter 13.

Recoveries on Postpetition Tort Recoveries Do (Do Not) Belong to Creditors in '13'

As long as the chapter 13 debtor completes payments under the plan as originally confirmed, Bankruptcy Judge Henry A. Callaway of Mobile, Ala., is allowing the debtor to keep any recovery resulting from a postpetition personal injury claim.

The fact that proceeds from a postpetition personal injury claim would become part of the chapter 13 estate wasn't determinative for Judge Callaway. He parsed the statute to show how the best interests test, applied as of the filing date, keeps postpetition tort proceeds out of the hands of creditors, even though the proceeds became part of the chapter 13 estate.

The Recurrent Problem Regarding Tort Claims

After plan confirmation, chapter 13 debtors sometimes have auto accidents or sustain personal injuries. Some courts rule that proceeds from postpetition tort claims go into the chapter 13 estate to increase whatever distribution the creditors were slated to receive on confirmation.

As a result, debtors end up with no recovery. If the debtor's car was "totaled" after confirmation, a check from the insurance company for the debtor's equity would go to creditors, leaving the debtor with nothing to purchase a new auto.

Or, suppose the debtor sustained a physical injury after confirmation due to someone else's negligence. Some courts would give the recovery to creditors as an enhancement to whatever the plan originally earmarked for them. The debtor would be left with pain and disfigurement, without compensation.

The problem is particularly poignant in a state like Alabama, where the state's personal property exemption is about \$8,000. Chapter 13 debtors in Alabama ordinarily will have exhausted their exemptions in confirming plans, leaving them with nothing to cover tort claims arising later.

In his May 30 opinion, Judge Callaway dealt with two cases having similar facts. One case suffices to demonstrate the situation.



The debtor confirmed a chapter 13 plan in 2018, using up her state personal property exemption. The plan had the debtor paying about \$850 a month under a five-year plan, giving unsecured creditors a 40% dividend.

After confirmation, the debtor was seriously injured. With court authorization, the debtor hired an attorney to pursue a tort claim. The result was a \$45,000 settlement that Judge Callaway approved.

After attorneys' fees and medical bills, the net was about \$20,000.

Laying claim to the \$20,000, the chapter 13 trustee filed a motion to modify the long-confirmed plan. Were the trustee to prevail, the creditors' recovery would rise to almost 80% while the debtor would receive nothing for her injuries, pain, suffering and disfigurement.

In his May 30 opinion, Judge Callaway refused to modify the plan, with a caveat designed to ensure that creditors would recover 40% before the debtor can touch the tort recovery.

The Statute

On the trustee's motion to modify the plan, two statutory provisions came into play: the best interests test in Section 1325(a)(4), and the disposable income test in Section 1325(b). Under Section 1329(b)(1), both apply in confirming a plan modification via Section 1322(a), (b) and (c).

In addition, Section 1306(a)(1) brings after-acquired property, like a tort claim, into the chapter 13 estate.

Citing authorities, Judge Callaway said that some courts "mischaracterize" personal injury proceeds as "income." He said, "Income and assets are different concepts." Furthermore, he said that the projected disposable income test and the liquidation test are separate, not stacked, citing *In re Ertha*, 18-855 (Bankr. S.D. Ala. Dec. 2, 2021).

"In short," Judge Callaway held, "the Section 1325(b) disposable income test does not apply to the settlement proceeds here because those proceeds are not 'income.'"

Furthermore, Judge Callaway said that the "plain language" of Sections 348(f) and 541 does not bring postpetition personal injury claims into a hypothetical chapter 7 case for inclusion in the Section 1325(a)(4) liquidation test. That's so because Section 1325(a)(4) is based on the value of estate property "as of the effective date of the plan."



Although the hypothetical chapter 7 liquidation test applies to plan modifications, Judge Callaway said that personal injury claims would not be part of the estate were the case converted to chapter 7, assuming no bad faith.

Citing the *Collier* treatise, Judge Callaway held that a personal injury claim “is thus not included in the liquidation analysis because that claim would not be part of a hypothetical chapter 7 under either Section 541(a) or Section 348(f).” Judge Callaway cited other courts reaching the same conclusion. See *In re Taylor*, 631 B.R. 346 (Bankr. D. Kan. 2021); and *In re Madrid*, 19-42260, 2023 WL 3563019 (Bankr. W.D. Wash. May 18, 2023). To read ABI’s reports on those cases, [click here](#) and [here](#).

Eleventh Circuit Precedent

Judge Callaway had a problem with an Eleventh Circuit opinion that runs counter to his statutory analysis. See *In re Waldron*, 536 F.3d 1239 (11th Cir. 2008).

In *Waldron*, Judge Callaway said that the appeals court applied an “ability to pay test” rather than the statutory liquidation and disposable income tests. However, he said that the circuit court only held that the debtor was obliged to schedule a postpetition personal injury claim.

Nonetheless, Judge Callaway said that courts in the Eleventh Circuit have held that postpetition assets, such as settlements, go to creditors “even though they would not have been included in the bankruptcy estate if the case were converted to chapter 7.”

To avoid offending *Waldron*, Judge Callaway said he would not change his practice and would require that the net settlement proceeds go to the trustee, but he added a wrinkle conceivably allowing the debtor to receive the tort settlement proceeds.

No Enhancement for Creditors

To conclude his opinion, Judge Callaway discussed whether settlement proceeds would enhance creditors’ recoveries. He said that the 40% recovery under the confirmed plan was *res judicata* and that calling for modification of the plan lay in the court’s discretion.

Judge Callaway cited other courts holding that an increase in income or a windfall is legitimate reason for plan modification. He said that a personal injury settlement is “categorically different” from windfalls like lottery winnings, inheritances or non-spousal insurance proceeds. When it’s a tort settlement, he said that the debtor would have given consideration in the form of injury to herself or to her property.

Judge Callaway held that the *Waldron* “ability to pay” standard did not apply.



To ensure that creditors receive what they were promised under the original plan, Judge Callaway directed the chapter 13 trustee to retain the net proceeds after paying the attorneys' fees and medical costs. Denying the motion to modify the plan, the opinion insinuates that the debtor will be entitled to the net proceeds once creditors have been paid their promised 40%.

Observations

The trustee is appealing to the district court. If the district court reflexively applies *Waldron*, the debtor will lose and receive no recovery for pain and suffering.

Respectfully, the Eleventh Circuit should revisit *Waldron*. When it comes to confirmation of an amended plan, Judge Callaway correctly says (in this writer's opinion) that the best interests test evaluates assets as of confirmation of the original plan. Similarly, the disposable income test looks at income, not assets.

The tort recovery was not income, and it was not an asset when the plan was first confirmed. Respectfully, the ability to pay should not govern a debtor's ability to retain net proceeds from the post-petition tort claim, when the proceeds were not income and were not an asset on the filing date.

[The opinion is](#) *In re Hill*, 18-2317 (Bankr. S.D. Ala. May 30, 2023).



One of the biggest unanswered questions in chapter 13 sometimes forces debtors to keep homes they need to sell or strips away appreciation if they are forced to sell.

'13' Debtors Need to Know Whether They Lose Appreciation When They Sell a Home

Congress desperately needs to amend the Bankruptcy Code and decide whether chapter 13 debtors are allowed to retain post-petition appreciation in the value of their homes.

Courts today are divided. In the worst case, the debtor may be compelled to turn the appreciation over to the trustee, not leaving enough for the debtor to purchase a new home in today's inflated market.

The case we report today led to a bad result for the debtor, in part because the lack of clarity in the law left counsel unable to give sound advice.

Home Destroyed by Fire

The debtor filed a chapter 13 petition owning a home she valued at about \$42,000, subject to a \$15,000 mortgage. She claimed a \$10,000 exemption under Virginia law.

Bankruptcy Judge Keith L. Phillips of Richmond confirmed the plan after the trustee withdrew an objection based on the value of the home. The 60-month plan called for payments of \$840 a month.

Although not mentioned in the opinion, the confirmation order revested estate property in the debtor.

The plan would pay off the mortgage on the home and the lien on a car. Unsecured creditors would receive 24%, better than the 23% liquidation value calculated by the debtor.

Twenty months after confirmation, a fire burned the home to the ground. The debtor filed an insurance claim and received some \$82,500 from the insurer. The insurer sent another \$8,500 to the lender, paying off the mortgage.

Seventeen months after receiving the insurance proceeds, the debtor consented to conversion of the case to chapter 7 after the chapter 13 trustee moved to dismiss for failure to make payments.



By that time, unsecured creditors had received 15% of their claims, and the debtor was still holding \$11,000 from the insurance proceeds.

While in chapter 13, the debtor did not amend her schedules to disclose the insurance proceeds. However, the debtor or her counsel on two occasions before conversion told the trustee about the fire and inquired about the disposition of some of the proceeds. Evidently, neither the debtor nor counsel disclosed the amount of the proceeds.

After conversion, the debtor filed new schedules disclosing the fire loss and giving a \$5,000 value for the uninhabitable property. The new schedules did not disclose receipt of insurance proceeds.

The chapter 7 trustee learned about the insurance and found that the debtor still held \$5,000 when he filed the motion to dismiss, according to the March 17 opinion by Judge Phillips. Alongside the motion to dismiss the chapter 7 case, the trustee wanted a two-year bar to refiling.

Finding the debtor's testimony to be credible, Judge Phillips said that the debtor had spent the insurance proceeds on personal expenses but not on luxuries.

Dismissal with Prejudice and a Bar to Refiling

Had the chapter 13 trustee or creditors known about the insurance proceeds, Judge Phillips said that someone "likely" would have moved to modify the plan and direct some or all of the proceeds to creditors.

According to Judge Phillips, another judge in the district said last year that debtors have a duty of cooperation with the trustee under Section 521(a)(3) and Rule 4002(a)(4), even though "the Bankruptcy Code and Federal Rules of Bankruptcy Procedure may not explicitly require the amendment of a debtor's schedules when an asset becomes property of a chapter 13 estate pursuant to § 1306(a)."

From the Code and the Rules, Judge Phillips concluded that a chapter 13 debtor had a duty to disclose a substantial and unanticipated change in the debtor's financial condition. Even if amending the chapter 13 schedules was not "technically required," he held that "their receipt required accurate and timely disclosure to the Chapter 13 Trustee."

The debtor argued that the proceeds were not estate property and that there was no duty to disclose. Citing authorities, Judge Phillips went on to hold that the "Proceeds of the policy insuring the [home] were property of the Debtor's chapter 13 estate that the Debtor could use only with court approval." Without disclosure, he said that "the Chapter 13 Trustee and her creditors were not afforded the opportunity to seek a plan modification."



Based on the “totality of the circumstances,” Judge Phillips held that the debtor had not acted in good faith, giving rise to dismissal for “cause” under Section 707(a). While a two-year bar to filing was “excessive,” he dismissed with prejudice and instituted a one-year bar to refiling.

Observations

Courts disagree about creditors’ entitlement to increments in a debtor’s assets during the course of a chapter 13 case. Some believe that creditors are entitled to boosted plan payments, while others believe that increased payments are due only if the debtor’s *earned* income has increased.

Likewise, Section 548(f)(1)(A) does not say who gets appreciation in property between the chapter 13 filing date and the date of conversion to chapter 7.

It’s no surprise that chapter 13 debtors’ counsel are in a quandary about actions to take when a home is sold or a debtor seeks to sell other property that has appreciated in value.

The sanctions imposed by Judge Phillips are not surprising given the debtor’s partial and perhaps misleading disclosures about the insurance. However, the sanctions imposed on the debtor raise a question under *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1799 (2019), where the Supreme Court held that a court “may impose civil contempt sanctions [for violating the discharge injunction] when there is no objectively reasonable basis for concluding that the creditor’s conduct might be lawful under the discharge order.” To read ABI’s report, [click here](#). The *Taggart* rule has been expanded to cover violations of the automatic stay.

Through *Taggart*, creditors are protected from contempt except when stay or discharge violations are beyond cavil. Should the same standard be applied before courts impose sanctions on debtors?

In the instant case, Judge Phillips said that the Code and Rules “may not explicitly require the amendment of a debtor’s schedules when an asset becomes property of a chapter 13 estate pursuant to § 1306(a).” With respect, it is also not absolutely clear that proceeds from a home are estate property after confirmation.

When there is no clear answer to a question, should *Taggart* protect debtors to the same extent it protects creditors?

[The opinion is](#) *In re Robinson*, 18-31989 (Bankr. E.D. Va. March 17, 2023).



Ninth Circuit BAP interprets Taylor and Schwab to mean that a trustee cannot revisit the value of an exempt asset if the debtor claimed '100% of FMV' and there was no timely exemption.

Claiming '100% of FMV,' Debtors Keep Postpetition Appreciation in Exempt Assets

Ruling on a question of first impression, the Ninth Circuit Bankruptcy Appellate Panel held that a debtor who claims an exemption equal to "100% fair market value" is entitled to retain postpetition appreciation in the value of the property, even if the chapter 11 case converts to chapter 7.

The opinion is important for another reason: If adopted widely, the BAP's analysis could end the split where courts disagree about a chapter 13 debtor's right to retain postpetition appreciation in the value of a homestead. If followed, the BAP's position regarding the finality of exemption claims would mean that debtors in cases that convert to chapter 7 from chapter 13 should retain post-petition appreciation regardless of whether the home was sold before or after conversion.

Typical Facts

The husband and wife debtors filed a chapter 11 petition in 2015. They scheduled their home as being worth about \$165,000 and encumbered by a \$130,000 mortgage. In the schedules, they claimed an exemption under Section 522(d)(1) for "100% of fair market value."

At the time, the exemption was \$45,900. No one lodged an objection to the exemption claim within the required time after the first meeting of creditors.

The bankruptcy court confirmed the debtor's chapter 11 plan in 2017. The plan called for retaining the home and continuing to pay the mortgage until maturity.

According to the BAP's November 2 opinion by Bankruptcy Judge Robert J. Faris, the plan was "muddled" but "appeared to claim [that] the entire fair market value of the home" was exempt. However, the plan recognized that the home would not be exempt until all creditors were fully paid under the plan.

The Dueling Motions



In 2018, more than one year after plan confirmation, the case converted to chapter 7. The debtors filed a motion to sell the home for \$400,000 and allow them to retain all net proceeds because the home was exempt.

The debtor withdrew their motion to sell when the trustee filed an objection stating that only the trustee had the right to sell estate property. Instead, the debtors filed a motion to compel the trustee to abandon the home, because it was 100% exempt, and no one had objected.

The chapter 7 trustee countered with a motion to sell the property and contended that the debtors were only entitled to the statutory \$45,900 exemption. All other net proceeds, the trustee said, should go to the estate and to creditors.

The bankruptcy court denied the debtor's motion to compel abandonment and granted the trustee's motion to sell. The trustee sold the home for \$422,000, generating net proceeds of almost \$225,000. On motion by the debtors, the bankruptcy court directed the trustee to hold the net proceeds pending resolution of appeals.

The debtors appealed to the BAP, successfully.

Mootness

The trustee argued that the appeal was statutorily moot under Section 363(m). The section provides that the "reversal or modification on appeal of an authorization . . . of a sale or lease of property does not affect the validity of a sale or lease . . . to an entity that purchased or leased such property in good faith, . . . unless such authorization and such sale or lease were stayed pending appeal."

Judge Faris ruled that the appeal was not statutorily moot because the debtors were only challenging the amount of the exemption claim and the distribution of the proceeds. They were not contesting the validity of the sale, he said.

Likewise, Judge Faris said that the appeal was not equitably moot, because reversal would not result in an "uncontrollable situation" since the trustee was holding funds to pay the debtors if they were to win on appeal.

At the end of the discussion of equitable mootness, Judge Faris alluded to the idea that the distribution of sale proceeds would have necessitated dismissing the appeal. He said,

Even if the Trustee had fully distributed the sale proceeds, he has not shown that it would be impossible or inequitable to claw back those payments from administrative and unsecured creditors. Thus, the Trustee has failed to demonstrate that equitable mootness requires the dismissal of this appeal.



The *dicta* by Judge Faris implies that the BAP would not reflexively dismiss an appeal if sale proceeds have been distributed.

The Merits

On the merits, Judge Faris first addressed the question of whether the absence of an objection to the homestead exemption claim meant that the exemption was valid, “even though it is larger than the law allows.”

In sum, Judge Faris said that the answer was beyond “any debate” in view of Section 522(l), Bankruptcy Rule 1019(2)(B)(i) and *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992). The section says, “Unless a party in interest objects, the property claimed as exempt on such list is exempt.”

Judge Faris said that “*Taylor* holds that § 522(l) means what it says: if no one files a timely objection, an exemption claim is valid even if it had no ‘colorable basis’ in the law.”

Even though the trustee had not been appointed when the debtors claimed their homestead exemption early in the chapter 11 case, Judge Faris said that “the rules make clear that he cannot now object.” Because there had been no objections to the exemption claim, he said it “is not subject to challenge.”

The FMV Claim

The second question, according to Judge Faris, was whether the debtors had claimed an exemption in the full market value of the home at filing or at the time of sale.

The Supreme Court’s decision in *Schwab v. Reilly*, 560 U.S. 770 (2010), “largely answered the second question,” Judge Faris said. He paraphrased *Schwab* as saying “that a debtor may claim ‘100% of FMV’ to put parties in interest on notice that he intends to claim the full value of the property as exempt.” Otherwise, the Court said, parties have no obligation to object if the debtor lodges an exemption claim in a dollar amount within the limits of Section 522(d).

Judge Faris said that the debtors followed *Schwab* “to the letter” by claiming an exemption in “100% of FMV,” or fair market value, and were entitled to the net proceeds even though the proceeds were in excess of the allowable exemption.

In addition to the chapter 7 trustee, the state had objected by contending that *Schwab* was mere *dicta* in counseling debtors to claim 100% of fair market value. Judge Faris said, “We do not agree that we can so easily reject language that the Supreme Court has approved for this very situation.”

The Snapshot Rule



Invoking the so-called snapshot rule, the trustee argued that the exemption was limited to the value of the property at filing and would not include appreciation. Judge Faris conceded that “postpetition appreciation of estate property inures to the benefit of the bankruptcy estate.”

Judge Faris described the workings of the snapshot rule as follows:

The snapshot rule fixes the point in time that defines the exemptions that a debtor is **entitled** to take. It says nothing about what happens when a debtor claims an exemption in postpetition appreciation to which the debtor is **not entitled** and no one timely objects. [Emphasis in original.]

To have the benefit of the snapshot rule, Judge Faris said that “a trustee or party in interest must object to an exemption claim that contradicts that rule.”

“As a matter of first impression,” Judge Faris said that the debtor’s “claim of an exemption equal to ‘100% of FMV’ includes postpetition appreciation and becomes incontestable if there is no timely objection.”

The BAP reversed the bankruptcy court’s order that had limited the exemption to the statutory maximum of \$45,950 and remanded for the bankruptcy court to determine how to enforce the exemption “and what other remedies, if any, are appropriate.”

Observations

On a related question, the courts are split. Does a chapter 13 debtor retain the appreciation in the value of homestead, whether or not the case converts to chapter 7?

So far, only the Tenth Circuit has answered the question, but only in the context of a sale before conversion. The Tenth Circuit held that nonexempt appreciation in the value of a home sold after confirmation of a chapter 13 plan belongs to the debtor, not to creditors, if the case converts to chapter 7 after the sale. The appeals court specifically declined to opine on the result if the debtors were to remain in chapter 13 after the sale. *See Rodriguez v. Barrera (In re Barrera)*, 22 F.4th 1217 (10th Cir. Jan. 19, 2022). To read ABI’s report, [click here](#).

Answering an open question after *Barrera*, Bankruptcy Judge Joseph G. Rosania, Jr., of Denver ruled that a chapter 13 debtor retains appreciation in the value of nonexempt property that the debtor owned on the filing date but was sold in the course of the chapter 13 case. *In re Klein*, 17-19106, 2022 BL 310082, 2022 WL 3902822 (Bankr. D. Colo. Aug. 23, 2022). To read ABI’s report, [click here](#).



Among judges holding otherwise, Bankruptcy Judge Marc Barreca of Seattle disagreed with the result later reached in the Tenth Circuit and with a fellow bankruptcy judge in the Ninth Circuit. Judge Barreca decided that the postpetition appreciation in the value of an asset belongs to the chapter 7 estate if the case converts from chapter 13. *In re Castleman*, 631 B.R. 914 (Bankr. W.D. Wash. June 4, 2021). For ABI's report, [click here](#).

The Ninth Circuit BAP's notion of the finality of an exemption would seem to mean that chapter 13 debtors retain postpetition appreciation in exempt assets regardless of whether the sale is during the chapter 13 case, before conversion to chapter 7 or after conversion.

This writer has a question about the renewal of objection periods permitted by Bankruptcy Rule 1019(2). Does the rule permit objections to exemptions that were made final by Section 522(1)? If that's so, is the rule invalid in some respect for contradicting the statute?

[The opinion is](#) *Masingale v. Muding (In re Masingale)*, 22-1016 (B.A.P. 9th Cir. Nov. 2, 2022).



Chapter 13 scholar Keith Lundin believes that debtors retain inheritances acquired more than 180 days after filing.

Do Debtors Get to Keep Post-Confirmation Windfalls in Chapter 13?

A chapter 13 debtor ties the score in the top half of the ninth inning in a game against the trustee. In the bottom half of the ninth inning, the trustee loads the bases with two outs. The batter for the trustee hits a long fly ball. Will it be caught to end the inning and win the game for the debtor, or will it go over the fence, with the trustee beating the debtor on a walkoff homer?

The case involves an inheritance the debtor received almost three years after confirming a chapter 13 plan. Will the debtor get to keep the inheritance or not?

Former Bankruptcy Judge Keith Lundin, the author of the treatise *Lundin on Chapter 13*, predicts that the debtor will win the game, perhaps in extra innings (that is to say, on appeal or after converting the case from chapter 13 to chapter 7).

The Inheritance

The debtor confirmed a 36-month chapter 13 plan with nothing for unsecured creditors on their \$25,000 in claims. The debtor paid \$140 a month over the life of the plan, for a total of \$5,040.

In the 31st month of the plan, the debtor received a \$72,000 inheritance on the death of her mother. After completing payments in the 37th month of the plan, the debtor informed the trustee about the inheritance and amended her schedules.

The debtor still had a wildcard exemption that could be applied to the inheritance. After the exemption, the trustee calculated that the \$58,000 net was estate property.

The chapter 13 trustee insisted that the debtor either pay 100% of filed claims or modify her plan to pay 100%. After the debtor declined, the chapter 13 trustee filed a motion asking Bankruptcy Judge Mary Jo Heston of Tacoma, Wash., to modify the plan under Section 1329(a) by increasing payments and extending the life of the plan.

The Seven Questions



In her May 18 opinion, Judge Heston marched through a string of questions to decide whether the debtor could keep the entire inheritance or part of it. First, she tackled the issue of whether the inheritance was property of the chapter 13 estate.

Two statutory provisions come into play. Section 541(a)(5) tells us that an inheritance becomes property of the estate if the debtor “acquires” the inheritance within 180 days of the filing date. In this case, the debtor acquired the inheritance long after the 180-day period.

“[I]n addition to the property specified in section 541,” Section 1306(a)(1) provides that estate property in chapter 13 includes “all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter [7](#), [11](#), or [12](#) of this title, whichever occurs first.”

Judge Heston refined the first question by asking “whether § 1306 extends the time frame under which inheritances become property of a chapter 13 bankruptcy estate beyond 180 days or whether § 541 sets a fixed time frame for the receipt of an inheritance under any chapter of the Code.”

Courts differ on the answer. Judge Heston elected to follow the majority of courts, citing the Fourth Circuit and the Ninth Circuit Bankruptcy Appellate Panel. *See Carroll v. Logan*, 735 F.3d 147, 152 (4th Cir. 2013) (holding that Section 1306 extends time frame set by Section 541 beyond 180 days in chapter 13 cases), and *Dale v. Maney (In re Dale)*, 505 B.R. 8, 13 (B.A.P. 9th Cir. 2014) (same).

Judge Heston found the BAP to be most persuasive and held that the post-petition inheritance became property of the estate under Section 1306(a)(1). In other words, Section 1306(a)(1) overrules or modifies the 180-day limitation in Section 541(a)(5).

Second, Judge Heston analyzed Section 1329 and decided that the trustee had the ability to modify the plan. Pointing to the debtor’s delay in notifying the trustee about receipt of the inheritance, she next concluded that equitable estoppel barred the debtor from relying on Section 1329(a) by claiming that the trustee could not modify the plan, since she had already made the last payment under her plan.

Fourth, Judge Heston asked whether a modified plan would satisfy the best interests test in Section 1325(a)(4). “[A]s of the effective date of the plan,” the section requires that distributions be not less than what unsecured creditors would receive in chapter 7. But what’s the effective date? Is it the date of confirmation of the original plan or the confirmation date of the amended plan?

Although she found no controlling authority, Judge Heston said that “most courts” believe that the “effective date” refers to the modified plan, meaning that the liquidation analysis must be “reapplied” when the plan is modified. She said that “the majority approach ensures that the plan



as modified accurately reflects what creditors might hope to receive in a chapter 7 liquidation if the debtor were to convert the case to chapter 7 today.”

For the fifth question, Judge Heston asked “whether the value of the non-exempt portion of the inheritance is included in a hypothetical liquidation, known as the best interest of the creditors test.”

Again, two sections were in competition. Section 1306 brings post-petition property into the estate, but what about Section 348(f)(1)(A)? When a case is converted from chapter 13, Section 348(f)(1)(A) says that “property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.” If conversion was in bad faith, subsection (f)(2) says that “the property of the estate in the converted case shall consist of the property of the estate as of the date of conversion.”

Naturally, the trustee contended that Section 1306 brought the inheritance into the estate. Judge Heston disagreed, handing the debtor an apparent victory under Section 348(f)(1)(A).

Judge Heston followed *In re Taylor*, 631 B.R. 346 (Bankr. D. Kan. 2021). She described the opinion by Bankruptcy Judge Dale L. Somers of Topeka, Kan., to mean that “the hypothetical chapter 7 estate does not include [the recovery on a post-petition personal injury claim] pursuant to § 348(f).” *Taylor* appears to mean that chapter 13 debtors retain post-petition inheritances, lottery winnings and other windfalls that have no connection to pre-petition assets. To read ABI’s report on *Taylor*, [click here](#).

If Section 1306 were to control, Judge Heston said that “liquidation value would be subject to constant upwards and downwards adjustments during the pendency of the case to account for any postconfirmation asset or liability acquired.” She also said that the adoption of Section 348(f) in 1994 “expressly overruled *In re Lybrook*, 951 F.2d 136 (7th Cir. 1991),” and removed a disincentive for filing in chapter 13.

Saying there were unresolved facts to govern whether conversion to chapter 7 would be in bad faith, Judge Heston identified a sixth question but did not decide whether Section 348(f)(2) would bring the inheritance into the estate.

Yogi Berra Precedent

At this point, the score was tied, or the debtor might have had a leg up, because Judge Heston’s ruling on Section 348(f)(1)(A) meant that the inheritance would not be included in the new liquidation analysis absent bad faith. But as Yogi Berra allegedly said, “It ain’t over ’til it’s over.”



On the penultimate page of her opinion, Judge Heston raised a seventh issue and dropped a bombshell when she said, without statutory authority:

In determining whether modification is warranted, the Court may in its discretion consider whether a debtor experienced a substantial and unanticipated change in her financial condition. *In re Mattson*, 468 B.R. 361, 370 (B.A.P. 9th Cir. 2012).

Citing the Fourth Circuit’s *Carrroll* opinion, Judge Heston found, “as a matter of its discretion, that the inheritance is a significant improvement in the Debtors’ financial condition that warrants increasing the distribution to unsecured creditors.” She therefore directed the debtor to “propose a modified plan that increases the distribution to unsecured creditors that meets the good faith requirements of § 1325(a)(3).”

Commentary

Former Bankruptcy Judge Lundin told ABI that “post-confirmation change in assets/income is probably the hottest topic going in the chapter 13 world, because post-petition assets and income are badly managed by the Code.”

Judge Lundin said that Judge Heston “correctly excluded the inheritance from the best-interests-of-creditors test analysis because of Section 348(f).” But then, he said, the opinion “jumps to ‘unforeseen, changed circumstances’ to allow a section 1329 modification without telling us what provision of Section 1329 captures the inheritance.”

Judge Lundin said that “1325(b) doesn’t apply at modification after confirmation under section 1329. So where is the hook? Is the inheritance ‘future income’ of some sort?”

Judge Lundin answered his own question by saying that “it can’t be the projected disposable income test in Section 1325(b) because an inheritance is not a substitute for wages or salary.” He cited the Ninth Circuit for having “rejected the notion that liquidation of an asset produces income for Section 1329 modification purposes.”

“Once the inheritance is excluded from the asset calculation in Section 1325(a)(4),” Judge Lundin said, “it doesn’t come back in through the income door.”

Judge Lundin’s analysis suggests that the debtor might succeed on appeal. To do so, she could modify her plan to satisfy Judge Heston and then appeal, asking the trustee to hold her extra payments pending appeal.



Or, the debtor might convert her case to chapter 7 as of right under Section 1307(b), if she were confident that conversion would not be in bad faith under Section 348(f)(2). Were she to convert, Judge Lundin said that the “debtor would keep the entire inheritance on a good faith conversion to chapter 7.”

The opinion is *In re Madrid*, 19-42260 (Bankr. W.D. Wash. May 18, 2023).



Joining the 'slight minority,' Judge Fenimore rules that post-petition appreciation in the value of a homestead goes to the chapter 7 estate when the chapter 13 case converts.

Chapter 7 Estate Takes Post-Petition Appreciation on Conversion from Chapter 13

Joining what he called the “slight minority of courts,” Chief Bankruptcy Judge Brian T. Fenimore of Kansas City, Mo., decided that the appreciation in the value of a homestead during a chapter 13 case belongs to the chapter 7 estate when the case converts.

In a footnote at the end of his November 10 opinion, Judge Fenimore was careful to say that his decision would have “no bearing on the estate’s interest in post-petition equity” had the case remained in chapter 13. In other words, debtors with nonexempt appreciation in a homestead should remain in chapter 13 because no circuit has definitively decided who gets the nonexempt equity if a home is sold after conversion from chapter 13 to chapter 7.

Typical Facts

The debtor filed a chapter 13 petition in August 2020 and confirmed a plan. The debtor scheduled her home as worth \$130,000 and claimed a \$15,000 homestead exemption. The home had a \$107,000 mortgage.

The parties agreed that the estate would have received nothing had the home been sold on the filing date.

The debtor converted her case to chapter 7 in April 2022. The parties agreed that the home had increased \$75,000 in value during the chapter 13 case. While in chapter 13, the debtor had reduced the mortgage by almost \$1,000.

To forestall an effort by the chapter 7 trustee to sell the home, the debtor filed a motion to compel the trustee to abandon the home under Section 554. The debtor contended that the home still had inconsequential value for the chapter 7 estate because the equity above the mortgage and the exemption were fixed as of the chapter 13 filing date when there was no objection to the claimed exemption.

In his November 10 opinion, Judge Fenimore denied the motion to compel abandonment.



The Split

Although no provision of the Bankruptcy Code is precisely on point, Section 348(f)(1)(A) comes close. When a chapter 13 case converts to a case under another chapter, it provides that “property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.” The section does not say who gets appreciation in property between the filing date and the date of conversion.

Harris v. Viegelaahn, 575 U.S. 510 (2015), also comes close. The Supreme Court said that property acquired after filing but before conversion does not become property of the chapter 7 estate, absent bad faith.

Judge Fenimore explained how the courts “disagree” about whether post-petition appreciation is “new” property that a debtor retains following conversion. The “slight majority” of courts, he said, hold that post-petition appreciation in the value of nonexempt property does not go to the chapter 7 estate.

Saying that he “respectfully disagrees” with the majority, Judge Fenimore followed what he called the “plain language” of the statute and awarded the increase in value to the chapter 7 estate.

Contrary to the analysis of the Tenth Circuit in *Rodriguez v. Barrera (In re Barrera)*, 22 F.4th 1217 (10th Cir. Jan. 19, 2022), Judge Fenimore saw appreciation as being “inseparable from the residence itself.” To read ABI’s report on *Barrera*, [click here](#). [Note: *Barrera* involved a home sold before conversion, not after.] To Judge Fenimore’s way of thinking, the broad definition of property of the estate in Section 541(a)(1) “captures the debtor’s entire ownership interest.”

Alluding to the definition of “equity” in *Black’s Law Dictionary*, Judge Fenimore said that “equity is not a separate item of property.” He found support for his conclusion from a Supreme Court tax case involving appreciated property.

Closer to home, Judge Fenimore cited the Eighth Circuit Bankruptcy Appellate Panel for saying that the estate’s interest is nothing less than “the entire asset, including any changes in its value which might occur after the date of filing.” *Potter v. Drewes (In re Drewes)*, 228 B.R. 422, 424 (B.A.P. 8th Cir. 1999). He therefore held that “the post-petition changes to the residence’s equity accrue for the benefit of the chapter 7 estate.” [Note: The statement in *Drewes* is probably *dicta* when applied to the case before Judge Fenimore but is persuasive nonetheless.]

Because the home and the appreciation in value were the same asset, Judge Fenimore denied the motion to compel abandonment.

Observations



There is no conflict between Judge Fenimore’s decision and the recent Ninth Circuit Bankruptcy Appellate Panel opinion in *Masingale v. Muding (In re Masingale)*, 22-1016, 2022 BL 394814 (B.A.P. 9th Cir. Nov. 2, 2022).

In *Masingale*, the BAP announced a theory allowing debtors to retain post-petition appreciation in the value of an exempt asset by claiming an exemption in “100% of fair market value,” as specified by the Supreme Court in *Schwab v. Reilly*, 560 U.S. 770 (2010). If there was no timely objection to the exemption, and if conversion occurs more than one year after confirmation, the exemption is final in a converted case, the BAP said.

In Judge Fenimore’s case, however, the debtor did not claim an exemption in 100% of fair market value. Instead, the opinion says that the debtor claimed a \$15,000 exemption in the equity above the mortgage. The Ninth Circuit BAP said that a debtor who claims an exemption in a specific dollar amount is stuck with that amount of an exemption in a converted case. To read ABI’s report on *Masingale*, [click here](#).

[The opinion is](#) *In re Goetz*, 20-41493 (Bankr. W.D. Mo. Nov. 10, 2022).



Wisconsin district judge implies that a chapter 13 debtor might obtain 'derivative standing' to avoid an unperfected mortgage.

Chapter 13 Debtor Can't Sue to Avoid an Unperfected Mortgage, District Judge Says

A decision by a district judge in Madison, Wis., highlights a problem that Congress ought to fix: Chapter 13 debtors should have statutory power to file avoidance actions, because Section 544(b)(1) only bestows the power on trustees.

Perhaps a congressional fix isn't necessary. As District Judge James D. Peterson said in his December 14 opinion, a chapter 13 debtor could seek derivative standing to sue in the name of the chapter 13 trustee. In the case before Judge Peterson, the chapter 13 debtor had not sought derivative standing.

The Unperfected Mortgage

A couple purchased a manufactured home and filed a chapter 13 petition two years later. The lender filed a secured proof of claim.

The debtors filed an avoidance action against the lender under Section 544(b)(1), contending that the lender had not properly perfected the security interest under state law. The bankruptcy court agreed with the debtors and avoided the security interest. In the process, the bankruptcy judge rejected the lender's argument that the chapter 13 trustee alone had statutory power to initiate the avoidance action.

The lender appealed and won, perhaps because the debtors had not sought derivative standing in bankruptcy court.

Section 544(b)(1)

The pivotal statute is Section 544(b)(1), which says that "*the trustee may avoid* any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an unsecured claim . . ." [Emphasis added.]

Judge Peterson said that neither the Supreme Court nor the Seventh Circuit has "directly addressed the question of" whether a chapter 13 debtor may exercise powers under Section 544(b)(1).



In the absence of controlling authority, Judge Peterson said that the “text of § 544(b)(1) is unambiguous: avoidance rights belong to the trustee. No other party is identified in the statute as having the right to invoke § 544.”

Judge Peterson found support for his conclusion in other provisions of the Bankruptcy Code. For instance, Section 1107(a) gives the powers of a trustee to a chapter 11 debtor in possession but not to a chapter 13 debtor. Similarly, Section 522(h) gives a debtor certain powers of a trustee, but none relevant to the case at bar.

Judge Peterson saw *Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000), as supporting his conclusion. In *Hartford*, an insurance company sought to recover the costs of preserving collateral under Section 506(c), but the Supreme Court ruled that the power only belongs to a trustee.

The debtors relied on three decisions from bankruptcy courts allowing chapter 13 debtors to bring avoidance suits. Judge Peterson was not persuaded. He said that all three were decided before *Hartford*.

Judge Peterson rejected the debtors’ argument that they were the “most appropriate party” to mount an avoidance action, because a trustee assuming the chore would incur expenses that might benefit only the debtors and not creditors. He responded by citing the Tenth Circuit Bankruptcy Appellate Panel for saying that avoidance actions are to benefit creditors, not debtors.

As a workaround, Judge Peterson alluded to the doctrine of derivative standing, where a court may allow a creditor or a creditors’ committee to sue in the place of a debtor or trustee. He noted that *Hartford* left open the question of derivative standing.

Judge Peterson said that the debtors had forfeited the idea of derivative standing because they had not raised the issue below.

Closing the opinion, Judge Peterson said that the court could not rely on “policy concerns” when the “unambiguous” statute gives power in Section 544 “only” to trustees.

Judge Peterson reversed and remanded, presumably for the bankruptcy court to dismiss the debtors’ avoidance suit.

Observations

To this writer, the opinion seems based in part on the assumption that avoiding the mortgage would benefit only the debtors and represent bad policy. This writer respectfully disagrees.



Were the debtors to avoid the mortgage, the economics of the chapter 13 case would change dramatically. Suddenly, the creditors would have a claim on the equity in the property above the homestead exemption. Furthermore, the avoided mortgage is not preserved for the benefit of the debtors.

“If the mortgage was avoided,” former Bankruptcy Judge Keith Lundin told ABI, “it would be preserved for the chapter 13 estate by Section 551 and then, things would get interesting. If debtors wanted to keep the property, they would have to pay the mortgage to the trustee or refinance or sell to pay the trustee and keep the excess under a modified plan.”

Indeed, Judge Lundin is correct. There might be little or no benefit to the debtors in avoiding the mortgage in chapter 13. Converting to chapter 7 could have a worse outcome, because the chapter 7 trustee might sell the house out from underneath the debtors.

Aiming to remain in chapter 13, the debtors would be obliged to raise enough cash to pay the creditors’ claims against the equity in the house. Raising the cash might entail selling the house or taking on a new mortgage. With rising rates, a new mortgage might be more costly than the avoided mortgage.

If the mortgage were avoided, Judge Lundin said, “It becomes ‘Let’s Make a Deal’ time with the chapter 13 trustee on one side and debtors scrambling on the other.”

Judge Lundin is one of the country’s leading commentators on chapter 13. See LundinOnChapter13.com.

[The opinion is](#) *21st Mortgage Corp. v. Warfel*, 22-88 (W.D. Wis. Dec. 14, 2022).



Claims



The circuits are now split 3/1, with the majority finding a waiver of sovereign immunity under Section 544(b)(1) for lawsuits by a trustee based on claims that an actual creditor could not have brought outside of bankruptcy.

IRS Has No Sovereign Immunity to Bar a Fraudulent Transfer Suit Under Section 544(b)

Siding with the majority on a split of circuits, the Tenth Circuit held that the waiver of sovereign immunity in Section 106(a) permits a bankruptcy trustee to sue the government for receipt of a fraudulent transfer under Section 544(b)(1), even though an actual creditor could not have sued the government outside of bankruptcy.

The Tenth Circuit found guidance from the sovereign immunity decision handed down by the Supreme Court in June. *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin*, 22-227, 2023 BL 204482, 2023 US Lexis 2544 (June 15, 2023). To read ABI's report, [click here](#).

The Fraudulent Transfer to the IRS

The case arose from a typical fraudulent transfer to the Internal Revenue Service: A corporation paid federal income taxes owed by one of its owners.

The corporation's chapter 7 trustee invoked Section 544(b)(1) to sue the IRS for receipt of a fraudulent transfer under Utah law. The section allows a trustee to "avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an [allowable] unsecured claim."

The government agreed there was an actual creditor and admitted the elements of a constructively fraudulent transfer. However, the government contended that sovereign immunity would have prevented an actual creditor from suing the IRS outside of bankruptcy, thus disabling the trustee from suing under Section 544(b)(1).

In response, the trustee argued that the waiver of sovereign immunity as to Section 544 contained in Section 106(a) allowed suit based on a state-law claim.

On cross motions for summary judgment, Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled in favor of the trustee and entered judgment for about \$145,000. The IRS appealed to



the circuit after the district court affirmed. See *U.S. v. Miller*, 20-00248, 2021 BL 340200 (D. Utah Sept. 08, 2021). To read ABI’s report on the district court affirmance, [click here](#).

The Circuit Split

In his June 27 opinion, Tenth Circuit Judge Bobby R. Baldock laid out the split of circuits.

The Seventh Circuit first tackled the question in 2014 by ruling that the immunity waiver in Section 106(a) did not allow suit against the state, reasoning that Section 106(a) did not modify the actual creditor requirement in Section 544(b). *In re Equip. Acquisition Res. Inc.*, 742 F.3d 743 (7th Cir. 2014). Judge Baldock said that the Chicago-based appeals court “never meaningfully addressed the scope of § 106(a) as reflected in its text.”

Judge Baldock interpreted the Seventh Circuit’s opinion as “effectively” erecting a “total ban” on fraudulent transfer suits against governmental units under Section 544(b)(1).

On the other side of the fence, the Ninth and Fourth Circuits both held that the waiver of immunity in Section 106(a) covers claims against the government under state law. See *In re DBSI, Inc.*, 869 F.3d 1004 (9th Cir. 2017); and *Cook v. U.S. (In re Yahweh Center Inc.)*, 27 F.4th 960 (4th Cir. 2022). To read ABI’s reports, [click here](#) and [here](#).

To decide which faction had the better reasoning, Judge Baldock took counsel from *Lac du Flambeau*, where the Court said that the intent of Congress to waive sovereign immunity must be “unmistakably clear,” although there is no requirement for the statute to use “magic words.”

Focusing on the language in Section 106(a), Judge Baldock noted that Congress “abrogated” immunity “with respect to” Section 544. The Supreme Court, he said, held that “with respect to” has a “broadening effect.”

Like the Fourth and Ninth Circuits, which were “faithful to the text of Code § 106(a),” Judge Baldock held:

[T]he critical phrase “with respect to” in § 106(a)(1) clearly expresses Congress’s intent to abolish the Government’s sovereign immunity in an avoidance proceeding arising under § 544(b)(1), regardless of the context in which the defense arises.

Judge Baldock found support for his holding in Section 106(a)(2), which says that the court “may hear and determine any issue arising *with respect to* the application of” Section 544. [Emphasis in original.]



Judge Baldock made “short work” of the government’s alternative argument based on field preemption. Had Congress believed that Section 544(b) posed an obstacle to the collection of income taxes, he said that “Congress surely would have added an express preemption provision to § 544(b) exempting the Government from its operation just as it provided an exemption for a transfer of charitable contributions in subsection (b)(2).”

Contrary to the Seventh Circuit, Judge Baldock held:

Code § 106(a) waives the Government’s sovereign immunity both as to the Trustee’s proceeding under Code § 544(b)(1) and the underlying Utah state law cause of action subsection (b)(1) authorizes the Trustee to rely on to avoid the debtor’s tax transfers made on behalf of its principals in this case.

[The opinion is](#) *U.S. v. Miller*, 21-4135 (10th Cir. June 27, 2023).



A secured lender who doesn't file a claim doesn't get paid by the chapter 13 plan and keeps its lien, but can't reclaim the collateral during the life of the plan.

Failing to File a Claim Has Dire Consequences for a Secured Creditor

What happens in chapter 13 if a secured creditor doesn't file a claim, and the debtor doesn't file a claim for the creditor? There are two schools of thought.

Here's the situation. The debtor owns a car. The plan provides for paying off the lien on the car over the life of the chapter 13 plan. However, the auto lender never files a proof of claim, and the debtor doesn't file a claim on behalf of the lender.

The plan is confirmed. After confirmation, the chapter 13 trustee files a motion to pay the lender nothing because no one filed a claim for the auto loan. The trustee proposes to redirect the money to other creditors that would have gone to the auto lender, accelerating the payment of the claims of other creditors.

There being no objection to modification of the plan, the bankruptcy court grants the motion.

The lender awakens and files a motion to modify the automatic stay, claiming a lack of adequate protection given that the lender would be receiving no payments during the life of the plan.

Two Schools of Thought

This question was presented to Bankruptcy Judge Robert E. Grant of Ft. Wayne, Ind.

Judge Grant answered an identical question seven years ago when he wrote *In re Jones*, 555 B.R. 869 (Bankr. N.D. Ind. 2016). Denying a motion to modify the stay, he called the lender's predicament a "self-inflicted wound." *Id.* at 870. He explained that the lender was receiving no payments because the lender had not filed a claim.

When presented with the same issue addressed in his March 8 opinion, Judge Grant said it was a "question of whether § 1327(a) means what it says." The section says that the



provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.

The lender had the chutzpah to ask Judge Grant to overrule his own holding in *Jones* because the bankruptcy and district courts in Wisconsin reached the opposite result in *In re Weyer*, 192 B.R. 612 (Bankr. W.D. Wis. 2020). *Weyer* believed that *Jones* was disregarding a secured creditor's right to adequate protection.

Judge Grant stuck to his guns. With "all due respect" to the authors of *Weyer*, Judge Grant said he was giving "force to the provisions of the Code and rules concerning the need to file claims and the effect of confirming a plan."

Why *Jones* Was Correct

Judge Grant based his decision on the *res judicata* effect of a confirmation order. He said that issues like adequate protection "become irrelevant once the plan has been confirmed and, after confirmation, grounds for relief from stay are 'generally limited to post-confirmation defaults on the debtor's plan,'" citing the *Collier* treatise among other authorities.

More particularly, he said that "adequate protection becomes irrelevant after a plan has been confirmed [because it] is only a temporary measure . . . designed to protect the creditor's interest between the filing of the petition and confirmation of a proposed plan," citing authorities. In other words, "the plan's provisions for the treatment of creditors replace preconfirmation arrangements," citing the treatise by former bankruptcy judge Keith Lundin, among other authorities.

Absent a default in carrying out the plan, Judge Grant said that Section 1327 precludes a creditor from seeking a modification of the automatic stay. "After confirmation, creditors are limited to asserting the interests provided for in the plan," he said.

No Windfall for the Debtor

Judge Grant explained why the result might not be such a great deal for the debtor: The lien will survive bankruptcy. Instead of emerging from chapter 13 owning his car free and clear, "the debtor will have to deal [with] that lien and [the lender's] right to enforce it at that time."

Not filing a claim has consequences, Judge Grant said. A creditor who doesn't file a claim doesn't get paid under the plan. It would be "a dangerous distortion of the Code" to grant relief from the stay in favor of a creditor who didn't file a claim, he said.



Denying the motion to modify the stay, Judge Grant said that “the fact that a statute may produce a result viewed as more favorable to one party than another is not a reason to refuse to enforce the statute.”

[The opinion is](#) *In re Ramirez Flores*, 22-10010 (Bankr. N.D. Ind. March 8, 2023).



The Fourth Circuit sides with the Third on the Affordable Care Act's 'individual mandate.' Majority says it was a tax measured by income, thus giving the IRS a priority tax claim.

Fourth and Third Circuits Give Priority to Obamacare's Individual Mandate Penalty

In a 2/1 decision, the Fourth Circuit employed a “functional analysis” to side with the Third Circuit in holding that the shared-responsibility payment, although called a “penalty” under the Affordable Care Act, was a tax on income afforded priority under the Bankruptcy Code.

The dissenter believes that the court instead was obliged to employ a traditional statutory analysis requiring the court to adopt the ACA’s characterization of the mandate as a penalty, which would not be a priority claim.

The Third Circuit opinion is *In re Szczyporski*, 34 F.4th 179 (3d Cir. May 11, 2022). To read ABI’s report, [click here](#). The Fourth Circuit’s majority also aligns with an opinion from the Sixth Circuit Bankruptcy Appellate Panel in *In re Juntoff*, 636 B.R. 868 (B.A.P. 6th Cir. Mar. 21, 2022). [Click here](#) to read ABI’s report on *Juntoff*.

The opinions no longer have practical significance, because Congress lowered the “penalty” to zero in 2017. However, the decisions will provide guidance should a future administration resurrect some form of universal health care with penalties for those who do not buy insurance.

Typical Facts

The debtors filed a chapter 13 petition in 2019. The Internal Revenue Service filed a \$30,000 priority claim that included \$2,400 for failure to comply with the individual mandate and to make the shared-responsibility payment in the debtors’ 2018 federal tax return.

The debtors objected to the portion of the claim based on the individual mandate, contending that it did not give rise to a tax on income or an excise tax on a “transaction” under Section 507(a)(8)(A) or (a)(8)(E). Rather, the debtors said it was a “penalty” not entitled to priority.

The bankruptcy court agreed with the debtors, calling the exaction a penalty not entitled to priority. The district court affirmed, only to be reversed by the Fourth Circuit panel’s majority on January 19.



The Majority Opinion

Every opinion about the priority of the individual mandate tussles with *National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012), where the Supreme Court held that the shared-responsibility payment was a tax for constitutional purposes but was not a tax for the Anti-Injunction Act.

For the majority, Circuit Judge William B. Traxler, Jr. said that Supreme Court authority required the court of appeals to employ a “functional analysis” in deciding whether the mandate gave rise to a tax, even though the ACA called it a “penalty.”

Given that the Supreme Court used a functional analysis in deciding that the exaction was a tax, Judge Traxler said “it would seem difficult for an intermediate court to reach a different conclusion.” Bound by the Supreme Court’s functional analysis, he held that the exaction was a tax, not a penalty.

Next, Judge Traxler analyzed whether the tax was “measured by income” and was thus entitled to priority under Section 507(a)(8)(A). Because “household income provides the starting point” for calculating the exaction, he had “no difficulty concluding” that it was a tax “measured by income.”

The majority reversed, holding that the exaction was a tax entitled to priority.

The Dissent

Circuit Judge Paul V. Neimeyer “respectfully” dissented. He believes “that [*Sebelius*] requires that the payment be treated as a penalty in the context of the Bankruptcy Code.”

Judge Neimeyer had a different interpretation of the Supreme Court’s analysis in *Sebelius*. Unlike the majority, he saw the high court as having used “two distinct analyses, one when construing the ACA’s statutory text and another when determining the scope of Congress’s constitutional authority for enacting the ACA.”

He saw the Supreme Court as having used a functional analysis on the constitutional question while employing “rules of statutory construction” in deciding how the ACA interacted “with another statute.”

Judge Neimeyer saw the case on appeal as “one of *statutory* interpretation — whether the shared responsibility payment is a penalty as so labeled by Congress in the ACA.” [Emphasis in original.]



“Given the plain meaning of the text,” Judge Neimeyer concluded “that Congress’s labeling it a penalty is controlling for purposes of other congressional enactments, and therefore it should be treated as a penalty in the Bankruptcy Code, which distinguishes penalties from taxes.” He said that congressional labels must “be honored,” even when the labels were inaccurate, citing *Sebelius*.

Saying that he would have affirmed, Judge Neimeyer felt obliged to “honor the congressional texts *as written*.” [Emphasis in original.]

[The opinion is](#) *U.S. v. Alicea*, 21-2220 (4th Cir. Jan. 19, 2023).



Cross-Border Insolvency & Puerto Rico



Federal courts have no jurisdiction to review decisions by Puerto Rico's Oversight Board regarding the reduction of pension benefits.

First Circuit Says: PROMESA Fiscal Plans Can't Be Challenged in Federal Court

The First Circuit won't countenance any erosion in PROMESA's jurisdictional preclusion of attacks on fiscal plans promulgated for instrumentalities of the Commonwealth of Puerto Rico by the Oversight Board.

Consequently, federal courts have no jurisdiction to prevent the Oversight Board from requiring the reduction in pensions owing to professors at the University of Puerto Rico.

The University's Retirement System

Beginning in 2017, Puerto Rico and some of its instrumentalities filed debt-adjustment proceedings under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et seq.*). PROMESA adopts large swaths of chapter 9, governing municipal bankruptcy.

The federally appointed Financial Oversight and Management Board was charged under PROMESA with developing fiscal plans for Puerto Rico and its instrumentalities.

The Oversight Board determined that the retirement system for professors at the University of Puerto Rico was facing insolvency. The Board eventually certified a fiscal plan saying that the university should freeze the defined benefit plan and adopt a defined contribution plan. The university's governing board approved the plan.

An association of university professors filed suit in the PROMESA proceedings against the Oversight Board and the university, contending that the Board had no authority over the retirement system. The professors also argued that the Board overstepped its authority in telling the university how to rectify the retirement plan's financial problems.

The Oversight Board moved to dismiss. Adopted by the district court, the magistrate judge granted the dismissal motion, ruling that the professors had no standing because they had not identified any injury-in-fact. The magistrate judge also said there was no jurisdiction under Section 106(e) of PROMESA.



The professors appealed to the circuit.

The Lack of Jurisdiction

Circuit Judge William J. Kayatta, Jr. upheld the district court in an opinion on February 14. He ruled on jurisdiction without reaching the question of standing.

The professors conceded that the university's retirement system was "covered" by PROMESA, thus allowing the Oversight Board to promulgate a fiscal plan. However, they argued that their objection was not to the Board's certification of the fiscal plan but to the scope of the Board's authority.

The outcome turned on Section 106(e) of PROMESA, 48 U.S.C. § 2126(e). It provides that "[t]here shall be no jurisdiction in any United States district court to review challenges to the Oversight Board's certification determinations under this Act."

Judge Kayatta began from the proposition that "PROMESA clearly authorized the Oversight Board to issue a fiscal plan for any covered Commonwealth instrumentality" and that the university is a "covered instrumentality."

Given the deprivation of jurisdiction in Section 106(e), he said that "the question [of] whether plaintiffs could challenge an unauthorized plan is irrelevant to the disposition of this appeal." He dismissed the professor's suit against the Oversight Board by quickly concluding that "section 106(e) precludes the district court from exercising jurisdiction over those claims."

Having dismissed claims against the Board, Judge Kayatta ended his opinion by discussing dismissal of claims against the university.

The professors admitted that supplemental jurisdiction was "the only basis for jurisdiction" over claims against the university. Judge Kayatta found "no argument that maintaining supplemental jurisdiction would be appropriate following the dismissal of the claims against the Oversight Board."

Without reaching the question of whether the plaintiffs had constitutional standing, Judge Kayatta upheld dismissal of the suit against both the Oversight Board and the university.

Updates on Related Puerto Rico Cases

One appeal involving PROMESA was argued in the Supreme Court on January 11, and *certiorari* was denied in another on February 21.



In *Financial Oversight & Management Board for Puerto Rico v. Centro de Periodismo Investigativo Inc.*, 35 F.4th 1 (1st Cir. May 17, 2022), the First Circuit held over a vigorous dissent that Section 106 of PROMESA waived sovereign immunity as to the Oversight Board. To read ABI's report, [click here](#).

The appeal was argued on January 11. The case will allow the Supreme Court to decide whether a general grant of jurisdiction is sufficient to waive sovereign immunity. The case in the Supreme Court is *Financial Oversight & Management Board for Puerto Rico v. Centro de Periodismo Investigativo Inc.*, 22-96 (Sup. Ct.).

In *Financial Oversight and Management Board for Puerto Rico v. Cooperativa de Ahorro y Credito Abraham Rosa (In re Financial Oversight and Management Board for Puerto Rico)*, 41 F.4th 29 (1st Cir. June 18, 2022), the First Circuit split with the Ninth Circuit by holding that just compensation for a government's taking of private property must be paid in full under the Fifth Amendment in the PROMESA proceedings and not at the discount afforded to holders of unsecured claims in a municipal bankruptcy.

The Supreme Court denied *certiorari* on February 21. The case in the Supreme Court was *Financial Oversight and Management Board for Puerto Rico v. Cooperativa de Ahorro y Credito Abraham Rosa*, 22-367 (Sup. Ct.)

[The opinion is](#) *Asociacion Puertorriquena de Profesores Universitarios v. University of Puerto Rico (In Financial Oversight & Management Board for Puerto Rico)*, 21-1690 (1st Cir. Feb. 14, 2023).



Being registered, plus having directors and an address, on the Isle of Man wasn't sufficient to show COMI or an 'establishment' justifying recognition under chapter 15.

A 'Letter Box' Company Denied Foreign Main and Nonmain Recognition in Chapter 15

The liquidation of a “letter box” company with no operations, assets or actual management on the Isle of Man was not entitled to either foreign main or foreign nonmain recognition under chapter 15, because the island was not the center of main interests, nor did the company have an “establishment” there, according to Bankruptcy Judge Janice D. Loyd of Oklahoma City.

Judge Loyd’s October 14 opinion stands in contrast to *In re Modern Land (China) Co., Ltd.*, 641 B.R. 768, 784 (Bankr. S.D.N.Y. July 18, 2022), where the bankruptcy court granted foreign main recognition to proceedings in the Cayman Islands, even though the company’s assets, management and business were in mainland China. In *Modern Land*, however, there was debt governed by New York law. Furthermore, the creditors were almost unanimous in their approval of a scheme of arrangement approved in the Caymans, and no creditor objected to recognition in the U.S. To read ABI’s report on *Modern Land*, [click here](#).

Prof. Jay L. Westbrook told ABI that he found the Oklahoma case “interesting . . . because mere incorporation was not enough to make the Isle of Man the COMI even though accompanied by the usual lineup of statutory offices and resident directors where the offices and the directors were all associated with the corporate service organization.”

The country’s leading authority on cross-border insolvency, Prof. Westbrook went on to say that the “court relies on *SPhinX [infra]*, which I regret, but nonetheless finds correctly that there was a failure of proof on COMI, especially where failure to produce knowledgeable management or liquidator witnesses permitted the court to make adverse inferences from their nonproduction.”

Prof. Westbrook is the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law.

The Liquidation on the Isle of Man

The debtor was a limited liability company that was incorporated in the Isle of Man and maintained its registered office there. It owned an aircraft and contracted to sell it to a third party,



after the completion of heavy maintenance. Two years later, disputes arose regarding the repairs. At the time, the escrow agent for the sale was holding more than \$500,000.

The escrow agent filed an interpleader action that ended up in federal district court in Oklahoma to determine whether the debtor, the repair shop or the buyer was entitled to the \$500,000. Later, the debtor was placed in a “creditors’ voluntary liquidation” on the Isle of Man, where a liquidator was appointed.

Four months later, the liquidator filed a petition in Oklahoma City for recognition of the proceedings on the Isle of Man as either a foreign main or nonmain proceeding under chapter 15.

The Paucity of Relevant Evidence

Regarding recognition, there was no dispute that the proceedings abroad were a “foreign proceeding” and that the liquidator was a “foreign representative.” Recognition turned on whether the liquidation abroad was a foreign main or nonmain proceeding as defined by Section 1502.

Under Section 1502(4), the proceedings would be foreign main if they were “pending in the country where the debtor has the center of its main interests,” or COMI. Under Section 1502(5), the proceedings abroad would be nonmain if they were being conducted “where the debtor has an establishment.” The debtor’s registered office is presumed to be the COMI under Section 1516(c). Of course, the presumption can be overcome.

The repair shop and the buyer opposed recognition as main or nonmain. To decide whether the presumption had been overcome and the liquidator was entitled to foreign main recognition, Judge Loyd applied the five-factor test from *In re SPhinX, Ltd.*, 351 B.R. 103 (Bankr. S.D.N.Y. 2006), *aff’d*, 371 B.R. 10 (S.D.N.Y. 2007).

The first factor was the location of the debtor’s headquarters.

The debtor’s address on the Isle of Man was that of a “worldwide corporate service company.” Although the debtor’s directors lived on the island, they were employees of the service company. As Judge Loyd said, the service company’s “corporate and governance services include[] acting as a registered office and providing directors.”

The liquidator testified that the debtor’s business model was to own an aircraft leased to an affiliate located in the Togalese Republic. Otherwise, there was no additional testimony about the debtor’s operations or actual management.

The lack of further evidence led Judge Loyd to conclude that the first factor was “neutral.”

The second factor inquires about the location of those who actually manage the debtor.



Because there was “no evidence” that the two employees from the service company “independently managed or exercised control,” Judge Loyd decided that the second factor “weights against a finding of COMI.”

The third factor is the debtor’s primary assets.

The debtor claimed an interest in the aircraft, which was in Delaware, and had some \$600,000 in a bank account in Switzerland, along with the \$500,000 held by the court in Oklahoma. Finding “no evidence” about assets on the Isle of Man, Judge Loyd held that the location of assets “weighs heavily” against a finding of COMI.

The fourth factor, the location of creditors, similarly weighed against COMI because there were none on the island.

The fifth factor is the law to govern “most” disputes. It was neutral because Judge Loyd had no evidence on the issue.

Judge Loyd held that the liquidator was not entitled to foreign main recognition because the *SPhinX* factors weighed against a finding of COMI on the Isle of Man.

Still, the proceeding could be “foreign nonmain” if there was an “establishment” on the Isle of Man.

To qualify for nonmain recognition, Judge Loyd said that “the foreign debtor must establish a degree of stable connections with the jurisdiction to constitute a nontransitory ‘establishment.’ 11 U.S.C. § 1502(2).” She cited authority for the proposition that mere incorporation and record-keeping is not enough. There must be “a local effect on the marketplace,” she said.

Judge Loyd found no establishment on the Isle of Man and therefore no right to nonmain recognition, because the liquidator had not shown that the debtor had not “sufficiently engaged the local economy.”

To contravene the findings, the liquidator contended that the buyer and the repair shop had waived the right to object because they both participated in the proceedings on the Isle of Man by voting in favor of the creditors’ voluntary liquidation.

Judge Loyd presumed that they were protecting their rights to share in a distribution. She declined to “infer” that the creditors waived “their substantive, statutory rights” to object to recognition.



Judge Loyd denied the liquidator’s petition for both foreign main and foreign nonmain recognition.

Commentary by Prof. Westbrook

Prof. Westbrook elaborated on “letter box” companies and COMI:

The point was made recently that the idea of jurisdiction of incorporation having broad jurisdiction over a corporation was invented by the English as a way of ensuring English law would control for an English corporation operating elsewhere in or out of the empire. I don’t know if that is true, but it is plausible and I intend to explore it, because *incorporation standing alone should never be a sufficient basis for COMI jurisdiction*. [Emphasis added.]

As Bankruptcy Judge Martin Glenn held, it certainly cannot be the basis for nonmain jurisdiction. Yet *SPhinX* makes too much turn on what “the parties” want, which is to say the parties with the means and incentive to show up in the U.S. court. The rock-solid core of COMI doctrine is, of course, the opinion of Judge Lifland in *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd.*, 389 B.R. 325 (S.D.N.Y. 2008), where the court takes on the burden of ensuring the COMI policy of Chapter 15 is enforced.

[The opinion is](#) *In re Comfort Jet Aviation Ltd.*, 22-10039 (Bankr. W.D. Okla. Oct. 14, 2022).



District judge holds that the safe harbor in Section 546(e) applies to lawsuits by foreign liquidators aiming to avoid transactions abroad under foreign law.

Madoff Fraud Makes More Law: The Safe Harbor's Application to Foreign Liquidators

The largest fraud in history, the Bernard Madoff Ponzi scheme continues making important law, often in the cross-border sphere. A district judge in New York has given greater definition about the extent to which the safe harbor in Section 546(e) limits the claims that a foreign liquidator can make in a U.S. court.

Several of Madoff's largest investors were so-called feeder funds located in the British Virgin Islands. They took money from their own investors and gave it to Madoff. In return for their money, the feeder funds issued shares to their investors.

Of course, the feeder funds blew up when the Madoff fraud surfaced. The feeder funds ended up in liquidations in the BVI. The liquidators filed 300 lawsuits in the U.S., aiming to recover \$6 billion that the investor-shareholders had taken out of the feeder funds by redeeming their stock.

Based on several theories under BVI law, the liquidators contended that the redemptions were based in bogus determinations about the value of the feeder funds' position with Madoff. Later, the liquidators filed chapter 15 petitions in New York and received so-called foreign main recognition. The lawsuits were removed to bankruptcy court.

Litigation proceeded for years both in the U.S. and all the way up to the Privy Council in England on appeal from decisions by the BVI court. The focus of this report is an August 24 opinion by District Judge Vincent S. Broderick affirming the bankruptcy court's dismissal in favor of the defendant-investors in the feeder funds.

Judge Broderick's opinion dealt with a plethora of issues, like personal jurisdiction on facts peculiar to the case. We shall focus on his rulings regarding the safe harbor in Section 546(e), which says that "the trustee may not avoid a transfer that is a . . . settlement payment . . . made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract, . . . except under section 548(a)(1)(A) of this title."

In broad brush, the investors in the feeder funds argued that their redemptions of stock in the feeder funds were payments on securities contracts immunized from avoidance by the safe harbor.



Before delving into the intricacies of Section 546(e), Judge Broderick explained the types of suits that a foreign liquidator can or cannot bring in the U.S. in chapter 15. Prominently, Section 1521(a)(7) bars a trustee from mounting preference or fraudulent transfer suits under Sections 547 and 548.

Citing authorities, Judge Broderick said that foreign liquidators “cannot raise avoidance claims under the U.S. Bankruptcy Code.” However, he said that lawsuits liquidators may bring under foreign law are “nevertheless subject to the Bankruptcy Code’s limitations” by virtue of Section 561(d).

That section says that “[a]ny provisions of [the Bankruptcy Code] relating to securities contracts . . . shall apply in a case under chapter 15.”

The liquidators, whose suits were dismissed by the bankruptcy court, argued that the safe harbor could not apply because the redemptions were foreign transactions. They also relied on the presumption against extraterritorial application because there is no indication in Section 546(e) that Congress intended for it to apply to foreign transactions.

Like the bankruptcy court, Judge Broderick said it didn’t matter whether Section 546(e) had extraterritorial application. He held that “Congress has expressed a clear intent to apply Section 546(e) extraterritorially through Section 561(b).” He went on to state the “natural conclusion . . . that the safe harbor from the foreign representatives’ avoidance powers applies to extraterritorial transfers as well.”

Judge Broderick said that foreign liquidators “cannot have it both ways” by availing themselves of a forum under chapter 15 while avoiding the limitations that chapter 15 imposes.

Next, the liquidators argued that their suits were based on “actual fraud” and that the safe harbor did not apply because their claims were akin to actual fraud under Section 548(a)(1)(A).

Judge Broderick agreed. “If there are exceptions to the limitation of the domestic trustee’s avoidance powers, then it should be the same with those of the foreign representative,” he said.

Still, Judge Broderick poured the claims down the drain, because the liquidators were not alleging claims for actual fraud. Instead, they were making claims for unfair preference or undervalued payment under BVI law.

Because the claims were not akin to Section 548(a)(1)(A), Judge Broderick upheld dismissal.

The liquidators are appealing to the Second Circuit.

[The opinion is](#) *Fairfield Sentry Ltd v. Citibank N.A.*, 19-3911 (S.D.N.Y. Aug. 24, 2022).

Faculty

Hon. Beth A. Buchanan is a U.S. Bankruptcy Judge for the Southern District of Ohio in Cincinnati, appointed on May 10, 2011. Prior to her appointment, she was a member of Frost Brown Todd LLC in its Bankruptcy and Restructuring Practice Group, where she practiced exclusively in the areas of bankruptcy and insolvency law, representing debtors, creditors' committees, secured lenders and unsecured creditors in numerous complex chapter 7, 11 and 15 bankruptcy proceedings. Prior to obtaining her law degree, Judge Buchanan worked in banking for over eight years with two major financial institutions. She is a member of ABI, the Cincinnati Bar Association, the Federal Bar Association's Cincinnati/Northern Kentucky Chapter, the National Conference of Bankruptcy Judges and the Thomas F. Waldron American Bankruptcy Law Forum, and she is the chairperson of the Local Bankruptcy Rules Standing Committee for the Southern District of Ohio. She also served on the Sixth Circuit Bankruptcy Appellate Panel from 2018-20. Judge Buchanan received her B.S.B.A. in 1986 from The Ohio State University and her J.D. *summa cum laude* in 1997 from the University of Dayton School of Law.

Hon. John E. Hoffman, Jr. is Chief U.S. Bankruptcy Judge for the Southern District of Ohio in Columbus, initially appointed in 2000 and named Chief Judge in October 2021. Previously, he was a partner in the Columbus office of Arter & Hadden LLP, where he practiced primarily in the areas of bankruptcy and commercial litigation, focusing on the representation of chapter 11 debtors and creditors' committees. He joined Arter & Hadden in 1989 after completing a judicial clerkship with Hon. R. Guy Cole, Jr., formerly a bankruptcy judge and now Chief Judge of the U.S. Court of Appeals for the Sixth Circuit. Chief Judge Hoffman has been involved in several national and local organizations dedicated to improving the administration of the bankruptcy system and the practice of law in the bankruptcy courts. He is a Fellow of the American College of Bankruptcy and a conferee of the National Bankruptcy Conference, and he has served the National Conference of Bankruptcy Judges as a member and chair of its Endowment for Education, as a member and chair of its Education Committee, and as a member of its Board of Governors. Chief Judge Hoffman is actively involved with The Ohio State University Moritz College of Law as both an adjunct professor of business bankruptcy and a member of its National Council. He is the 2015 recipient of its William K. Thomas Distinguished Jurist Award and the 2016 recipient of its Public Interest Law Foundation's Excellence in Public Service Award. Chief Judge Hoffman also has worked to make legal services available to those who cannot afford them, having served on the Board of Trustees for The Legal Aid Society of Columbus from 1995–2000. He received the Award for Outstanding Pro Bono Service by a judge from the Columbus Bar Association and Columbus Bar Foundation in 2012, and in 2015 he was presented with the Ohio State Bar Association's John and Ginny Elam Pro Bono Award, which is given in recognition of "exceptional volunteer service by a lawyer that advances the common good of the people of Ohio." Judge Hoffman received his B.A. *summa cum laude* from Wheeling Jesuit University in 1980 and his J.D. *magna cum laude* from The Ohio State University Moritz College of Law in 1983.

Hon. Guy R. Humphrey is a U.S. Bankruptcy Judge for the Southern District of Ohio in Dayton, appointed in 2007. Prior to his appointment, he practiced in the areas of debtor/creditor law, bankruptcy representation, receivership and litigation, representing a broad spectrum of clients, including individual debtors, business debtors, secured creditors, unsecured creditors, committees, and purchasers

of assets from financial institutions and bankruptcy estates. That representation spanned many industries, including manufacturing, real estate, lodging, retail, construction, restaurant and food service, transportation, utilities, financial institutions, and equipment sales and leasing. Judge Humphrey is a member of the National Conference of Bankruptcy Judges, ABI, the Thomas F. Waldron American Bankruptcy Law Forum, the American Bar Association, the Dayton Bar Association (Foundation Fellow) and the Federal Bar Association, and he served on the Bankruptcy Appellate Panel for the Sixth Circuit from 2013-18. In addition, he has served as a member of the Local Bankruptcy Rules Committee, the Bankruptcy Bench-Bar Conference Committee (Chair 2015-19) and the Complex Chapter 11 Procedures working group for the district. Both as a practitioner and as a judge, Judge Humphrey has been a presenter at numerous legal education seminars and conferences and has served as a mediator for many contested matters and proceedings. He also has enjoyed hosting many legal externs in his chambers and serving as a judge for the high school Robert N. Farquhar District Mock Trial Competition. Judge Humphrey received his undergraduate degree from Kent State University and his J.D. from The Ohio State University Moritz College of Law.

Hon. Mina Nami Khorrami is a U.S. Bankruptcy Judge for the Southern District of Ohio in Columbus and was appointed on Sept. 10, 2021, by the U.S. Court of Appeals for the Sixth Circuit. She began her career in St. Louis, Mo., where she practiced bankruptcy law and litigation as an associate with the firms of Vogler & Associates and then with Compton, Wells & Hamburg. While she practiced in St. Louis, she successfully argued a case before the U.S. Court of Appeals for the Eighth Circuit. In 1991, Judge Nami Khorrami relocated to Columbus to open her own firm. Her practice focused on more complex chapter 7 and 13 bankruptcies, including arguing before the Bankruptcy Appellate Panel of the U.S. Court of Appeals for the Sixth Circuit. She also handled general civil litigation, foreclosure defense, and issues relevant to small businesses. Prior to her appointment to the bench, she also served as a chapter 7 panel trustee. Judge Nami Khorrami has served on numerous committees of the Columbus Bankruptcy Bar and was a frequent speaker at CLE programs. She has long been committed to bankruptcy *pro bono* service in the Columbus community, and in 2013 she received the Columbus Bar Association and Foundation Award for her involvement in the implementation of the chapter 7 bankruptcy *pro bono* project in Columbus. Judge Nami Khorrami also served as vice-chair of the court's Attorney Advisory Committee and as co-chair of its Consumer/Small Business subcommittee. She is a past co-chair of the Columbus chapter of the International Women's Insolvency & Restructuring Confederation (IWIRC) and a past co-chair of the Bankruptcy Law Institute's (BLI's) Planning Committee. She also served on the board of trustees for the Credit Education Coalition (CEC) and was a member of the Chapter 13 Liaison Committee. Judge Nami Khorrami received her B.S. in business administration from the University of Missouri-St. Louis and her J.D. from Valparaiso University School of Law.

Hon. C. Kathryn Preston is a U.S. Bankruptcy Judge for the Southern District of Ohio in Columbus. After law school, she clerked for Hon. Alexander L. Paskay in Tampa, Fla., and later for Hon. Donald E. Calhoun, Jr. In between clerkships, she practiced law with the boutique bankruptcy firm of Stichter & Riedel, PA in Tampa. After clerking for Judge Calhoun, she joined the legal department of a large regional bank, where she had a general business practice, including bankruptcy and loan workouts. During her tenure at the bank, she also took a segue into the business arena, when she supervised management of the bank's troubled commercial loan portfolio. On Jan. 1, 2012, Judge Preston was appointed to the Sixth Circuit Bankruptcy Appellate Panel; she was reappointed in January 2015, and served as chief judge of the BAP from January 2015 to October 2017. She is a member of the Nation-

al Conference of Bankruptcy Judges, The Florida Bar, Columbus Bar Association, Women Lawyers of Franklin County, ABI, and other bar associations and community organizations. Judge Preston received her B.A. from Stetson University and her J.D. from Stetson University College of Law.

William J. Rochelle, III is ABI's editor-at-large, based in New York. He joined ABI in 2015 and writes every day on developments in consumer and reorganization law. For the prior nine years, Mr. Rochelle was the bankruptcy columnist for Bloomberg News. Before turning to journalism, he practiced bankruptcy law for 35 years, including 17 years as a partner in the New York office of Fulbright & Jaworski LLP. In addition to writing, Mr. Rochelle travels the country for ABI, speaking to bar groups and professional organizations on hot topics in the turnaround community and trends in consumer bankruptcies. He earned his undergraduate and law degrees from Columbia University, where he was a Harlan Fiske Stone Scholar.

Hon. Gregory R. Schaaf is Chief U.S. Bankruptcy Judge for the Eastern District of Kentucky in Lexington, initially appointed on Oct. 1, 2012, and named Chief Judge on Oct. 1, 2019. Prior to his appointment, he practiced in the areas of commercial reorganizations, including bankruptcies and workouts, and commercial transactions, including energy-related matters. He represented debtors, creditors' committees, trustees and individual creditors. Judge Schaaf is a CPA and worked as a solicitor in London from 1997-99, handling corporate matters and real estate transactions for English, Russian and American clients. He is a Fellow of the American College of Bankruptcy and is Board Certified in Business Bankruptcy Law and Consumer Bankruptcy Law by the American Board of Certification. Judge Schaaf received his B.B. in accounting and his B.S. in law enforcement administration from Western Illinois University in 1984 with high honors, and his J.D. in 1991 from the University of Kentucky College of Law, where he was a member of the Order of the Coif and participated in its national moot court team and on its moot court board, as well as on the school's *Journal of Mineral Law and Policy*.