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**Recognizing Red Flags and Avoiding Rule 9011:
Recent Bankruptcy Cases**

The Honorable Clifton R. Jessup, Jr.¹
United States Bankruptcy Judge
Northern District of Alabama

October 1, 2021
ABI Midwestern Bankruptcy Institute

¹ Presentation materials prepared with the assistance of Melissa H. Brown, law clerk to the Honorable Clifton R. Jessup, Jr.

I. PREPETITION RED FLAGS AND RULE 9011

Recognizing and understanding red flags before and during the pendency of a bankruptcy can lessen the risk of liability and avoid Rule 9011 sanctions, including the disgorgement of fees. The following recent cases serve as a reminder regarding pitfalls which can easily be avoided by relying on your training, making full disclosure, and avoiding shortcuts in bankruptcy cases.

A. Failure to Recognize Red Flags Can Lead to Sanctions for Filing an Unauthorized Petition

In re Santos, 616 B.R. 332 (Bankr. N.D. Tex. 2020)(Jernigan, J.): Counsel filed an unauthorized petition on behalf of a new client’s ex-wife using her social security number without ever meeting with or speaking with the ex-wife in person, and without entering into a written contract with her to stop the foreclosure of the client’s home. The bankruptcy court had entered an order dismissing the client’s third case and barring him from refile for 180 days. After counsel explained to the client that he was not eligible for relief, the client assured counsel that his ex-wife was willing to file bankruptcy to prevent the foreclosure of their former marital home, but stated that she was unable to meet in person due to a death in the family. In reality, the client’s ex-wife had refused to file when asked by her ex-husband to do so because she was relieved to no longer have any financial obligations with her ex-husband from whom she had been divorced 10 years. After counsel filed the petition, the ex-wife received a credit alert and discovered that a petition had been filed in her name. On hearing to show cause why counsel should not be sanctioned for filing an unauthorized petition, the bankruptcy court stated that the following “red flags” should have alerted counsel about the problem of filing the petition:

- Counsel knew the debtor’s wet signature was required, but ignored his knowledge and proceeded to file the petition, schedules, statement of financial affairs, and other documents without the ex-wife’s wet signature.
- The ex-husband paid counsel’s fee of \$3,500 in cash. “A person with \$3,500 cash-in-hand wanting to file bankruptcy in someone else’s name is unusual, to say the least”²
- The address provided by the ex-husband as his ex-wife’s current address for the petition was the same as the client’s address even though the client had stated that his ex-wife would need to go to her apartment to obtain her tax returns.

² *In re Santos*, 616 B.R. 332, 342 (Bankr. N.D. Tex. 2020).

- Counsel failed to verbally communicate with the ex-wife, accepting the ex-husband's statement that his ex-wife could not speak on the phone because she was attending a funeral.

B. Failure to Update Financial Information in Subsequent Case Can Lead to Rule 9011 Sanctions

***In re Thomas*, 612 B.R. 46 (Bankr. E.D. Pa. 2020)(Frank, J.):** Counsel violated Rule 9011(b)(3) by failing to reasonably inquire into facts averred in the debtor's bankruptcy schedules. The debtor voluntarily dismissed her first Chapter 13 case prior to confirmation after the bankruptcy court lifted the stay to allow her former partner in a brokerage firm to pursue state court litigation for breach of contract. Six months later, counsel filed a second Chapter 13 case on behalf of the debtor without updating any of the financial information in the debtor's schedules.

- During the first case, twenty-two creditors filed proofs of claim most of which were secured by mortgages. The schedules in the second case failed to account for or report the existence of numerous secured claims filed in the first case, clear red flags. Instead, counsel filed schedules in the second case that were essentially identical to the original schedules filed in the first case.
- To deter counsel from filing another case without considering or preparing updated schedules, the bankruptcy court entered sanctions denying counsel's administrative expense claim, required counsel to pay \$1,000 to the U.S. Trustee for the benefit of the estate, and referred the matter to the U.S. Trustee for possible suspension.

C. Failure to Run Pre-Petition Lien Search Can Constitute Malpractice

***In re Horvath*, 2021 WL 371771 (Bankr. N. D. Ohio 2021)(Kendig, J.):** Debtors moved to reopen a case in which they received a Chapter 7 discharge in 2009 to avoid a judgment lien under 11 U.S.C. § 522(f). The judgment creditor opposed the motion to reopen and argued that laches prevented the decade-late avoidance attempt. The debtors did not dispute that the lien existed at the time they filed their bankruptcy case and there was no suggestion that the lien was not properly recorded. Not only were the records available through a simple online search of county records, electronic services providing public record searches were also available.

- The bankruptcy court denied the motion to reopen and emphasized the importance of lien searches (on-line real estate title compilations, on-line lien searches, tax "scripts") in analyzing whether sanctions should be imposed on counsel under 11 U.S.C. § 707(b)(4)(C).

- The need for an attorney's prepetition due diligence, including lien searches, cannot be understated.
- “[A] petition presented to the court certifies the representations contained therein are presented ‘to the best of the person's knowledge, information and belief, formed after an inquiry reasonable under the circumstances.’ Failure to adhere to this duty may open counsel to sanctions. Rule 9011(b) is enhanced by newer Code provisions, including 11 U.S.C. § 707(b)(4)(C)(i) (signature of counsel certifies s/he ‘performed a reasonable investigation into the circumstances that gave rise to the petition [and it is] well grounded in fact’), and 11 U.S.C. § 707(b)(4)(D) (specifying the signature is ‘a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect’). An attorney has a clear duty to make a reasonable investigation into the facts contained in the petition, schedules and other pleadings presented to the court.”³
- Even if not aware of the judgment lien, the debtors were bound by their attorney’s act or omission.

D. Failure to File Sworn, Verified Schedules and Statements Can Lead to Rule 9011 Sanctions

***In re Pina*, 602 B.R. 72 (Bankr. S.D. Fla. 2019)(Olson, J.):** Counsel for the debtor moved to withdraw as counsel after the Chapter 7 Trustee filed an Adversary Proceeding seeking to revoke the debtor’s discharge based on numerous errors discovered in the debtor’s schedules. Thereafter, the Chapter 7 trustee discovered that the debtor never saw nor approved the schedules filed by counsel. Following a hearing on show cause, the court discovered that it was counsel’s standard practice in more than 100 cases to have debtors sign preliminary draft schedules and statements which counsel later completed and filed without further review by the debtors.

- Rule 1008 requires all schedules and statements to be verified or contain an unsworn declaration under penalty of perjury pursuant to 28 U.S.C. § 1746. The electronic filing system depends upon the integrity of lawyers filing papers that have been properly verified and signed. A debtor’s schedules “are the starting point for the evaluation of a debtor’s assets and liabilities, and the starting point for the evaluation of a debtor’s honesty.”⁴ “[W]ithout that starting point, the bankruptcy process lacks fundamental integrity.”⁵

³ *In re Horvath*, 2021 WL 371771 *2 (Bankr. N. D. Ohio 2021).

⁴ *In re Pina*, 602 B.R. 72, 95 (Bankr. S.D. Fla. 2019).

⁵ *Id.*

- Counsel violated Rule 9011(b) and made false representations to the bankruptcy court by passing off schedules and statements as having been verified or executed under penalty of perjury, when they were not actually verified.
- The bankruptcy court explained that the harm perpetrated by counsel went beyond the injury to counsel’s clients and other parties in interest. “The credibility of bankruptcy jurisprudence, including its courts, judges, and lawyers, is diluted with each fallacious case like these.”⁶
- The bankruptcy court suspended counsel from practicing before the court for two years and referred counsel to the state bar recommending disbarment.

II. AVOIDING THE PITFALL OF FEE DISGORGEMENT

A. The “Default Sanction” for Violation of Fee Disclosure Obligations is Full Disgorgement, Not the “Least Severe Sanction” Required to Deter Future Violations

***SE Property Holdings, LLC v. Stewart (In re Stewart)*, 970 F.3d 1255 (10th Cir. 2020):** Counsel received \$348,404.41 in fees for representing Chapter 7 debtors and failed to disclose his fee agreements and payments as required by § 329(a) and Rule 2016(b), until ordered to do so more than two years after the agreements should have been disclosed. Counsel obtained an interest in settlement proceeds under an undisclosed fee-sharing agreement related to the debtor’s BP oil spill claims. Counsel “credited” \$144,591 to fees owed for his bankruptcy work. The remaining fee came from net settlement proceeds owed to one of the debtors’ business affiliates which had guaranteed counsel’s legal fees in connection with the bankruptcy case.

Once discovered, the debtors’ largest creditor filed a motion seeking disgorgement. The debtors’ attorney argued that the fees were not for services rendered “in connection with the bankruptcy case” and that same were not paid from property of the estate. The bankruptcy court found the arguments to be meritless, but only required counsel to pay \$25,000 to the estate, relying in part on cases involving Rule 9011 violations under which appropriate sanctions include those that are the least severe to deter future misconduct. The BAP affirmed. The Tenth Circuit reversed, finding that the bankruptcy court abused its discretion.

- Section 329(a) of the Bankruptcy Code and Rule 2016(b) require “every attorney representing a debtor in bankruptcy to file with the court [within 14 days of the order for relief] a statement of all compensation received during the preceding year, or to be received, in connection with the bankruptcy.”⁷

⁶ *Id.* (quoting *In re Garrard*, 2013 WL 4009324 at *6 (Bankr. N.D. Ala. 2013)(Robinson, J.)).

⁷ *SE Property Holdings, LLC v. Stewart (In re Stewart)*, 970 F.3d 1255, 1258 (10th Cir. 2020)(quoting *Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1127 (7th Cir. 2003)).

- “Attorneys for debtors perform an essential role ... [b]ut when it comes to compensation, they play second fiddle to creditors.”⁸
- An attorney’s duty of disclosure under § 329(a) and Rule 2016(a) “is that of a fiduciary.”⁹ Violations of this fiduciary duty are intolerable, thus the sanctions must be “harsh, going far beyond the need to compensate for the damage done or even to deter the specific offender.”¹⁰
- “The bankruptcy system functions on the premise that the overwhelming majority of those who utilize it are honest, that those who are dishonest are [not] likely to be caught, and that the penalties for dishonesty are severe.”¹¹
- Full disgorgement is the default sanction for noncompliance with § 329 and Rule 2016. There must be compelling, mitigating circumstances supported by solid evidence for a court to impose anything less.

B. Failure to Turnover Settlement Proceeds Can Result in Disgorgement of Fees and in Special Counsel Being Held Jointly Liable with the Debtor for the Full Amount of Settlement Proceeds

Morris v. King (In re Rosales, Jr.), 621 B.R. 903 (Bankr. D. Kan. 2020)(Herren, J.): In a case converted from Chapter 7 to Chapter 13 and back to Chapter 7, the Chapter 7 trustee filed a Complaint for Turnover pursuant to 11 U.S.C. § 542(a) against special counsel seeking turnover of the full settlement amount and disgorgement of fees and expenses paid to special counsel while the case was pending under Chapter 13. When the case was originally filed under Chapter 7, the trustee filed separate applications to employ counsel to represent the estate as special counsel in the debtor’s personal injury case. A few months later, the debtor converted to Chapter 13 and special counsel substituted the debtor as the plaintiff in the state court action. Thereafter, the debtor filed an application to employ one of the attorneys to represent the Chapter 13 estate without referencing the fee sharing agreement with the second attorney. Pursuant to the terms of the debtor’s confirmed plan, the net settlement proceeds were to be used to pay claims and the debtor was prohibited from using the proceeds without prior court order.

Subsequently, the debtor accepted a settlement which was not sufficient to complete her case. Special counsel distributed \$14,545.63 to the debtor; \$2,894.30 to the second attorney for his share of the contingency fee; and retained \$5,060.07 for his fees and expenses. Neither attorney filed a fee application or motion for approval of their fees

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Id.

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Id. at 1263.

¹⁰

Id.

¹¹

Id. 1265 (quoting *In re Lewis*, 309 B.R. 597, 602-03 (Bankr. N.D. Okla. 2004)).

pursuant to Rule 2016(a), nor a supplemental statement pursuant to Rule 2016(b) within fourteen days of receipt of the compensation. When the debtor failed to remit the proceeds to the Chapter 13 trustee, the trustee moved to re-convert the case to Chapter 7 under § 1306(c)(6) for material default.

After failing to collect the net settlement proceeds from the debtor, the Chapter 7 trustee filed an action against special counsel seeking turnover. Special counsel argued that they represented the Chapter 13 debtor, not the bankruptcy estate, and that § 327 and Rule 9019 do not apply to a debtor in possession.

- Section 542(a) requires a trustee to establish: (1) the property sought to be turned over is property of the estate; (2) the party against whom turnover is sought is an entity; (3) the entity was in possession, custody, or control of property of the estate during the case; and (4) the trustee may use or sell the property.
- The prepetition cause of action constituted property of the estate under § 541(a)(1) which includes “all legal or equitable interests of the debtor in property as of the commencement of the case.”
- Pursuant to § 348(a), conversion of the case to Chapter 13 and reconversion to Chapter 7 did not change the commencement date of the case nor remove the prepetition cause of action from property of the estate.
 - Upon conversion to Chapter 13, the claim remained property of the estate pursuant to § 1306(a) which incorporates § 541(a) property as property of the Chapter 13 estate.
 - Upon reconversion to Chapter 7, Rule 1019(4) required the debtor, as the debtor in possession, to turn over all property of the estate in her possession or control to the Chapter 7 trustee.
- Relying in part upon the Tenth Circuit’s *In re Stewart* opinion, the bankruptcy court ordered special counsel to disgorge their fees and held lead counsel jointly liable with the debtor for turnover of the amount of settlement proceeds that he possessed, had custody of, or controlled during the case. Although *Stewart* pertained to disclosure of compensation under § 329(a) and Rule 2016(b), the bankruptcy court explained that the concerns underlying full and complete disclosure of compensation raised in *Stewart* applied equally to obtaining court approval of attorney fees paid from property of the estate under Rule 2016(a) and § 330(b)(4)(B).
- Disgorgement applies equally to an attorney that fails to seek court approval “even

though the attorney may have done meritorious work.”¹²

- There were no mitigating circumstances warranting less than full disgorgement. Special counsel was jointly liable for the full amount of any settlement proceeds independently controlled by counsel during the case. Thus, the lead attorney who first held the settlement proceeds in his trust account was jointly liable with the debtor for the amount distributed to the debtor.

C. Failure to Disclose a De Minimus Pre-Petition Claim Against a Debtor Can Result in Complete Disallowance of Compensation

***In re Greater Blessed Assurance Apostolic Temple, Inc.*, 628 B.R. 554 (Bankr. M.D. Fla. 2021)(Jennemann, J.):** The U.S. Trustee objected to counsel’s application for compensation in the amount of \$92,050 because counsel failed to disclose his prepetition representation of the Chapter 11 debtor for which he was owed \$1,505. Prior to the debtor’s second unsuccessful attempt to confirm its plan of reorganization, counsel filed an application for compensation for services rendered before the petition date through the date of the fee application.

- Under § 101(14)(A), the definition of “disinterested person,” includes a person that is “not a creditor,” and the term “creditor” is defined as “an entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor.”
- Counsel was not a disinterested person as defined under § 101(14)(A) and should not have sought retention under § 329 as debtor’s counsel without disclosing his disinterestedness, or first waiving the claim.
- Debtor’s counsel must make sure that they are either owed no pre-petition fees when the case is filed, or disclose any amounts due and waive the right to payment.
- Counsel cannot “usurp the court’s function by unilaterally choosing which connections impact on his disinterestedness and which do not.”¹³
- The duty to disclose does not end when employment is approved, and “[t]here is no *de minimus* threshold excusing an attorney from failing to disclose his inability to meet the required ‘disinterestedness’ status.”¹⁴

¹² *Morris v. King (In re Rosales, Jr.)*, 621 B.R. 903, 930 (Bankr. D. Kan. 2020)(quoting *In re Brown*, 371 B.R. 486, 500 (Bankr. N.D. Okla. 2007)).

¹³ *In re Greater Blessed Assurance Apostolic Temple, Inc.*, 628 B.R. 554, 558 (Bankr. M.D. Fla. 2021)(quoting *Keller Fin. Servs. of Florida, Inc.*, 243 B.R. 806, 812 (Bankr. M.D. Fla. 1999)).

¹⁴ *Id.* at 559.

- Counsel was not allowed “any compensation from the Debtor under § 328 of the Bankruptcy Code.”¹⁵

D. Failure to File Case in Good Faith Can Lead to Full Disgorgement of Fees, Plus Payment of Attorney Fees Incurred by Creditor in Connection with the Case

In re Midland Properties II, LLC, 2016 WL 3637708 (Bankr. D. Neb. 2016)(Saladino, J.): Counsel filed a Chapter 11 petition on behalf of Midland Properties, LLC (“Midland”), an entity which owned several rental properties. First State Bank held mortgages on a number of the properties and was owed more than \$1 million as of the petition date. Under Midland’s confirmed plan, First State Bank’s claims were to be paid over a term of five years and unsecured creditors were to receive quarterly distributions of \$5,000.00 for five years. After Midland defaulted on its plan payments, the bank obtained relief from the stay to proceed with foreclosure. The debtors appealed, but did not request a stay pending appeal.

While the appeal was pending, Midland’s sole managing member transferred Midland’s properties to Midland Properties II, LLC (“MPII”). Then counsel filed a new Chapter 11 case on behalf of MPII to “buy time” while the appeal remained pending without informing either First State Bank or the Bankruptcy Appellate Panel that Midland had deeded the property to the new entity which had also filed bankruptcy, thereby mooting the appeal. First State Bank obtained dismissal of MPII’s case on the grounds that the case was filed in bad faith, for the sole purpose of hindering First State Bank from enforcing its security interest. Then First State Bank pursued sanctions and disgorgement against both the debtor and counsel.

- The bankruptcy court imposed sanctions under Rule 9011(c), which forbids a lawyer from filing frivolous, improper, or unsupported filings, as well as § 11 U.S.C. 105(a), which authorizes the court to take action to prevent an abuse of process.
- The bankruptcy court explained that Rule 9011 is critical for the bankruptcy system to function, stating:

The typical federal court disposes of hundreds of cases each year—a bankruptcy court disposes of thousands. It is not uncommon to see dozens of attorneys in a bankruptcy courtroom, presenting arguments and objections on a long list of cases, with rulings issued at a pace that makes a cattle auction appear leisurely. A bankruptcy court does not have the time district courts devote to a motion, to examine each petition, proof of claim, and objection; the bankruptcy judge must rely on counsel to act in good faith. The potential for mischief to be caused by an attorney who is willing to skirt ethical obligations and procedural rules is enormous.¹⁶

¹⁵ *Id.*

¹⁶ *In re Midland Properties II, LLC*, 2016 WL 3637708 *3 (Bankr. D. Neb. 2016)(quoting *Young v. Young (In re Young)* 789 F.3d 872, 879 (8th Cir. 2015)(quoting *In re Anderson*, 487 B.R. 767, 774 (E.D. Tex. 2012)).

- While filing for relief on the eve of foreclosure is not itself considered bad faith, the actions leading to the transfer of First State Bank’s collateral without court permission were clearly done in bad faith, warranting both dismissal of the case as well as sanctions against counsel under Rule 9011.
- “[T]o impose a Rule 9011 sanction the court must find that an attorney ‘submitted a claim that has no chance of success under existing precedents and that fails to advance a reasonable argument to extend, modify, or reverse the law as it stands.’”¹⁷
- The court stated that “an attorney who should have known a reorganization was futile before filing the petition has rendered no service to the estate and should therefore not be compensated for such service.”¹⁸

III. PRACTICE POINTERS TO AVOID RULE 9011 SANCTIONS AND FEE DISGORGEMENT

A. Recognizing Red Flags if Representing Consumer Debtors

- **Be Alert:** To avoid potential bankruptcy mine fields listen to your intuition, rely on your training, and investigate red flags.¹⁹
 - i. **Screen clients prior to the initial conference.** Is the debtor a serial filer? Has the debtor been represented by multiple attorneys in prior cases? Has the debtor been barred from refiling?
 - ii. **Consider potential conflicts.** Are a husband and wife in agreement regarding their bankruptcy strategy or do your instincts tell you that they are headed for divorce? Will the owner of a business also need to file for relief? Certain conflicts may be reconciled, “but only if there is full disclosure from the onset.”²⁰
 - iii. **Timing is crucial.** Is the client eligible for relief under Chapter 7 or Chapter 13? A Chapter 7 discharge may not be obtained within eight years of a prior Chapter 7 discharge, or in many cases, within six years of a prior Chapter 13 discharge. *See* § 727(a)(8), (9). Will a Motion to Extend or Impose the Stay be required? *See* 11 U.S.C. § 362(c)(3)(B)[extension of the stay must be completed before the expiration of the 30-day period after the order for relief]; *See* 11 U.S.C. § 362(c) (4)(B) [request to impose the stay must be filed within the 30-day period].
 - iv. **Do your pre-filing homework to avoid future malpractice claims.**

¹⁷ *Id.* at *6 (quoting *Am. Residential Mortg., LP v. Thayer (In re Thayer)*, 384 B.R. 546, 552-53 (B.A.P. 8th Cir. 2008)).

¹⁸ *Id.*

¹⁹ *See* Hon. James M. Marlar, Karen L. Kellett & Randy Nussbaum, *ABCs of Representing Consumers in Bankruptcy Cases, Potential Malpractice Pitfalls in Bankruptcy*, ABI 18TH ANNUAL SOUTHWEST BANKR. CONFERENCE (2010)(outlining bankruptcy mine fields).

²⁰ *Id.*

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- Access state court systems to search for lawsuits and judgment liens.
- Access real estate records to obtain real estate ownership and recorded mortgages.²¹
- **Counsel Clients:** Prior to filing, counsel debtors regarding their duties throughout the case and the consequences for failing to fulfill their duties: *See* 11 U.S.C. § 521 and Rule 4002.
 - making Chapter 13 plan payments;
 - seeking Court permission prior to selling or purchasing assets;
 - reporting postpetition causes of action, inheritances, and other changes in circumstances.
- **Calendar Case Deadlines:**
 - Motions to Extend the Stay. [*See* 11 U.S.C. § 362(c)(3) - must be heard within 30 days after the petition date.]
 - Chapter 13 Plan Payments. [*See* 11 U.S.C. § 1326(a)(1) – payments must commence not later than 30 days after the petition date.]
 - Complaint Objecting to Discharge. [*See* Rule 4004(a) – must be filed no later than 60 days after the first date set for the § 341 meeting.]
 - Complaint Objecting to Dischargeability Under § 523(c) [*See* Rule 4007(c) – must be filed no later than 60 days after the first date set for the § 341 meeting.]

B. Recognizing Red Flags Before Representing Commercial Debtors²²

- Is management fulfilling its fiduciary duties?
- Are directors meeting and communicating with management?
- Does the client avoid communicating with counsel, fail to answer questions, fail to take advice?
- Has the client hired multiple attorneys prior to employing counsel?
- Are post-petition vendors being paid?

²¹ *See* Claire Ann Resop, *ABCs of Representing Consumers in Bankruptcy Cases, Examination of Bankruptcy Laws and Procedures Relating to Chapter 7 Consumer Bankruptcies*, ABI 18TH ANNUAL SOUTHWEST BANKR. CONFERENCE (2010).

²² *See* Steven K. Kortanek et al., *Professional Liability: Landmines and Tripwires*, ABI MID ATLANTIC BANKR. WORKSHOP (2005).

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A Few Lessons From The Neiman Marcus Case

October 1, 2021



Judge Chris Lopez

Neiman Marcus

The Neiman Marcus logo, which consists of the brand name in a cursive script font enclosed within a thin black rectangular border.

- In May 2020, the Neiman Marcus debtors filed chapter 11 bankruptcy cases in the Southern District of Texas.
- The Debtors' funded debt obligations totaled about \$5.5 billion.
- The Debtors' non-Debtor affiliates owned and operated MyTheresa.
- MyTheresa is an e-commerce retailer that appeals to younger luxury customers, primarily from Europe, Asia, and the Middle East.



The MYTHERESA logo, featuring the brand name in a bold, uppercase, sans-serif font with a white outline, set against a dark blue background.

2

Neiman Marcus

- Before the petition date, MyTheresa was transferred out of the Debtors' debt structure.
- Some creditors filed lawsuits alleging that the MyTheresa transfer was designed to keep the company away from the reach of creditors.
- One of the creditors who sued prepetition was Marble Ridge Capital, a private equity company founded by Daniel Kamensky.

Neiman Marcus Bondholder Sues Over Transfer of MyTheresa Business
Marble Ridge Capital says moving the e-commerce unit to Neiman's parent company was a fraudulent transfer



<https://www.wsj.com/articles/neiman-marcus-bondholder-sues-over-transfer-of-mytheresa-business>

3

Neiman Marcus

- In the Neiman Marcus bankruptcy cases, Marble Ridge was appointed to the Official Committee of Unsecured Creditors and served as a co-chair.
- "The chief purpose of an official committee is to maximize distribution to this class." *In re New Century TRS Holdings, Inc.*, Case No. 07-10416, 2013 WL 5377962, at *4 (Bankr. D. Del. Sept. 26, 2013).
- Creditors' committees owe a fiduciary duty to all unsecured creditors and are required to place the collective interest of unsecured creditors "above their own personal stake in the bankruptcy case." *In re Residential Cap., LLC*, 480 B.R. 550, 559 (Bankr. S.D.N.Y. 2012).



4

Neiman Marcus

- “[A] committee member’s fiduciary duties do not preclude it from representing its own interests, provided that in so doing it does not abuse its position on the committee at the expense of the creditor class.”
In re Refco Inc., 336 B.R. 187, 198 n.13 (Bankr. S.D.N.Y. 2006).
- Breach of a committee member’s duties include using its position on the committee to monopolize negotiations, freeze out other bidders, or exploit confidential information known only to it through its committee service.
In re Rickel & Assocs., Inc., 272 B.R. 74, 100 (Bankr. S.D.N.Y. 2002).



5

Neiman Marcus

- Marble Ridge, with the benefit of information obtained as a member of the Committee, offered to purchase potential estate causes of action about the MyTheresa transaction.
 - Mr. Kamensky submitted the offer to the Debtors’ disinterested manager on behalf Marble Ridge.
 - Committee counsel was not informed in advance about the offer.
 - Marble Ridge eventually withdrew the offer.
- In July 2020, the Committee was working on a proposed settlement of MyTheresa related disputes. The settlement included transferring MyTheresa Series B Preferred Stock to certain classes of unsecured creditors.
- The Series B Preferred Stock was highly illiquid, so the Committee explored a potential “cash out” option for unsecured creditors.



6

Neiman Marcus

The Next Part Is Well Documented

- Marble Ridge discussed a proposal with the Committee providing that it would backstop the purchase of 60 million Series B shares for \$.20/share from unsecured creditors electing the cash-out option.
- Marble Ridge later learned that Jefferies was preparing to make a higher bid for the shares.
- Mr. Kamensky contacted Jefferies and demanded that it drop its bid if Jefferies wanted to keep its business relationship with Marble Ridge.



7

Neiman Marcus

- Jefferies tells Committee counsel that it was withdrawing from the process, but it was transparent about the reasons.
- The Committee quickly contacted the UST and filed a letter with the Court under seal detailing concerns about Mr. Kamensky's actions.
- The Court unsealed the letter and ordered the UST to investigate.

The United States Trustee is directed to file a statement of position within 14 days regarding the conduct of Marble Ridge and Mr. Kamensky in this case. The United States Trustee's investigation should include all conduct of Marble Ridge and Mr. Kamensky since appointment to the UCC. The UCC's professionals are directed to provide all information in their possession concerning these matters to the United States Trustee. Upon reviewing the United States Trustee's statement, the Court will schedule a further hearing to determine what action, if any, should be taken.



8

Neiman Marcus

- The UST released a report concluding that “Marble Ridge, through Mr. Kamensky, breached its fiduciary duty of loyalty to the creditors it represented by coercing an outside investor to refrain from bidding against Marble Ridge on a key transaction that was considered integral to a successful plan of reorganization.”
- In August 2020, Marble Ridge publicly announced it would wind-down.
- In September 2020, Mr. Kamensky was indicted.
- In February 2021, he pled guilty to bankruptcy fraud related to the Neiman Marcus bankruptcy cases.
 - He was sentenced to six-months in prison.



A Few Lessons

- When a grave error is committed, admit it and don't make matters worse.
 - Arguing “the other side misunderstood” to a bankruptcy judge is not recommended.
- Lawyers must remain cognizant of their ethical duties before and throughout a case.
 - Ethics trainings are important and necessary.



A Few Lessons

- Committee representation is hard work.
 - Firms who represent committees generally have standard operating procedures. But difficult situations require creative solutions.
 - Committee counsel correctly contacted the UST and informed the Court.

A creditors' committee in a large commercial case serves an especially important role in the bankruptcy process. A properly functioning committee adds transparency and public confidence to a complicated and often confusing process. The Court relies on a committee's views to add depth and balance to the myriad of commercial issues that it considers. Any threat that endangers this delicate balance must be resolved promptly and in a public manner.
Court Order, Dkt. No. 1442

- Be mindful of potential collusive behavior and 11 U.S.C. § 363(n).
 - Not a direct Neiman Marcus issue, but important to keep in mind.

EXHIBIT 1



ENTERED
08/05/2020

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re: § Chapter 11
NEIMAN MARCUS GROUP LTD LLC, et al., § Case No. 20-32519 (DRJ)
Debtors. § Jointly Administered

ORDER
(Docket Nos. 1427, 1428, 1431, 1432)

On August 3, 2019, the Official Committee of Unsecured Creditors (the “UCC”) filed a sealed document at Docket No. 1427 along with a motion to seal at Docket No. 1428. The motion was filed in accordance with the applicable rules and practices in the Southern District of Texas. The sealed document at Docket No. 1427 is a letter from counsel for the UCC to the United States Trustee identifying concerns about certain actions by a committee member. The Court has carefully studied the contents of the letter over the past 48 hours and finds the described actions to be alarming. If the letter is accurate, the actions of Marble Ridge Capital LP (“Marble Ridge”) and its principal, Dan Kamensky, potentially implicate 11 U.S.C. § 510(c) as well as 18 U.S.C. § 152.

In an apparent attempt to mitigate the impact of the UCC’s letter, counsel for Marble Ridge filed the sealed declaration of Edward Weisfelner, counsel for Marble Ridge, on August 4, 2020 at Docket No. 1432. Marble Ridge simultaneously filed its own motion to seal Mr. Weisfelner’s declaration at Docket No. 1431. In taking this action, Mr. Weisfelner promoted himself to the status of a witness in this matter. Mr. Weisfelner is advised to review the governing ethics rules regarding his continued participation as counsel for Marble Ridge in this matter.

A creditors’ committee in a large commercial case serves an especially important role in the bankruptcy process. A properly functioning committee adds transparency and public confidence to a complicated and often confusing process. The Court relies on a committee’s views to add depth and balance to the myriad of commercial issues that it considers. Any threat that endangers this delicate balance must be resolved promptly and in a public manner. Although the Court understands the reason that the UCC’s letter was filed under seal, the Court finds that transparency demands that interested parties have the opportunity to evaluate the actions taken by Marble Ridge while acting as a fiduciary in this case. Accordingly, it is

ORDERED THAT:

1. The motion to seal filed by the UCC at Docket No. 1428 is denied.
2. The motion to seal filed by Marble Ridge at Docket No. 1431 is denied.
3. The Clerk is directed to immediately unseal Docket Nos. 1427 and 1432.

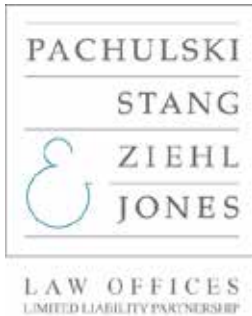
4. The United States Trustee is directed to file a statement of position within 14 days regarding the conduct of Marble Ridge and Mr. Kamensky in this case. The United States Trustee's investigation should include all conduct of Marble Ridge and Mr. Kamensky since appointment to the UCC. The UCC's professionals are directed to provide all information in their possession concerning these matters to the United States Trustee. Upon reviewing the United States Trustee's statement, the Court will schedule a further hearing to determine what action, if any, should be taken.

Signed: August 05, 2020.



DAVID R. JONES
UNITED STATES BANKRUPTCY JUDGE

EXHIBIT 2



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Richard M. Pachulski

August 2, 2020

310.772.2342
rpachulski@pszjlaw.com

VIA E-MAIL

Hector Duran
Office of U.S. Trustee
515 Rusk Street, Suite 3516
Houston, TX 77002
Email: hector.duran.jr@usdoj.gov

Re: Neiman Marcus – Committee Issue

Dear Mr. Duran:

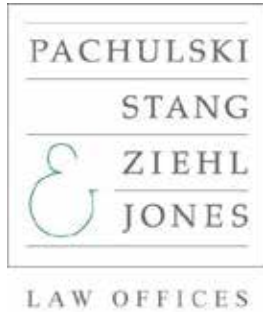
As you know, my firm is lead counsel, and Cole Schotz, PC is co-counsel, to the Official Committee of Unsecured Creditors (the “**Committee**”) in the pending chapter 11 cases of Neiman Marcus Group LTD LLC, *et al.* (together, the “**Debtors**”). We are writing to advise your office of certain background and communications (much of which Michael Warner of Cole Schotz and I communicated to you by phone yesterday, August 1, 2020), about certain events involving one of the members of the Committee, Dan Kamensky (“**Kamensky**”) as the representative of Marble Ridge Capital LP (“**Marble Ridge**”).

The relevant background and communications are described below:

1. On Wednesday, July 29, 2020, at a Committee meeting (the “**July 29 Committee Meeting**”), the Committee agreed, subject to certain conditions, to support a settlement and resolution of issues arising out of what has been referred to as the MyTheresa distribution. The proposed settlement includes the Debtors, their equity sponsors, and their lender constituents, and contemplates a proposed chapter 11 plan that will include the *pro rata* distribution of 140 million Series B preferred shares (the “**Series B Shares**”) in MYT Holding Co. (the “**MyTheresa Distribution**”) to the holders

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of allowed general unsecured claims in Classes 10 and 11 of the Debtors' Plan (the "**MyTheresa Settlement**"). No lender deficiency claims would be allowed to share in the MyTheresa Distribution. The terms of the MyTheresa Settlement were incorporated into the amended Plan attached to the Debtors' Disclosure Statement, which Disclosure Statement was presented to and approved by the Court on Thursday, July 30, 2020.

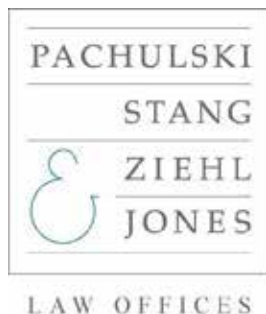
2. Marble Ridge was appointed as a Committee member by your Office and Kamensky was the representative of Marble Ridge on the Committee.
3. Even prior to agreeing to the MyTheresa Settlement, the Committee recognized that there could be interest by some unsecured creditors to convert the Series B Shares into cash. The Series B Shares are illiquid because they are only payable in the event of an asset disposition or other liquidation event. The Series B Shares are subordinate to at least \$200 million of senior debt owed to the Debtors' second lien noteholders and \$250 million of Series A preferred shares held by the Debtors' third lien noteholders. In connection with the Committee's various discussions, Kamensky advised the Committee that, at the appropriate time if a settlement were reached, Marble Ridge would be prepared to discuss with the Committee a cash-out option, funded by Marble Ridge for those unsecured creditors of the Debtors' estates who were interested in receiving cash instead of the Series B Shares. It was suggested that such a cash-out option may be selected by certain trade creditors and landlords who traditionally prefer cash over illiquid securities.
4. Immediately after the Committee approved the MyTheresa Settlement in the July 29 Committee Meeting, the Committee authorized me to enter into discussions with Marble Ridge to potentially structure a cash-out option for unsecured creditors: either they could retain their *pro rata* share of the Series B Shares or they could receive a cash payment funded by Marble Ridge to monetize the Series B Shares. The July 29 Committee Meeting included discussions regarding Marble Ridge's proposal. Marble



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Ridge, its representatives, and counsel were excluded from that portion of the meeting. In such discussions, the Committee addressed the requirement that if a transaction for a cash-out option proposed by Marble Ridge was supported by the Committee, Marble Ridge would have to agree to refrain from objecting to the Debtors' Plan, in order to provide what has been the Committee's consistent objective of global peace and expedited resolution and reorganization of the Debtors. The Committee further discussed Marble Ridge's offer of a cash-out option of \$0.20 per Series B Share. In effect, the Marble Ridge proposal would provide a cash-out option to any unsecured creditor who preferred to liquidate its share of the MyTheresa Distribution, rather than wait on a contingent recovery of what is today an illiquid instrument but could later equal up to \$1.00 per share. The Committee and its professionals recognized that many details needed to be addressed, but the discussions were to commence immediately with Marble Ridge.

5. From immediately following the July 29 Committee Meeting through the evening of July 30, 2020, I negotiated with Kamensky. As you are aware, mid-day on July 30, the Court heard and considered the Debtors' Disclosure Statement, which incorporated the MyTheresa Settlement reached the day before. At the Disclosure Statement Hearing, the Committee requested that the Court provide the Debtors, the Committee, and other relevant constituencies time to make changes to both the Disclosure Statement and the proposed Plan before the solicitation process commenced. The Committee requested such time so that the terms of the Disclosure Statement and the Plan could be fine-tuned. In addition, the Committee wanted time to potentially incorporate a cash-out option for unsecured creditors. The Court accommodated the request and set a further hearing, if necessary, for August 3, 2020. In recognition of the need to complete the documents quickly, so that the solicitation process was not delayed, I worked expeditiously with Kamensky. It was anticipated that, if the Committee was successful in its negotiations with Kamensky, the cash-out option might have been incorporated in the Debtors' Plan. No formal written proposal had been provided by Kamensky to the Committee as of the morning of Friday, July 31, 2020.

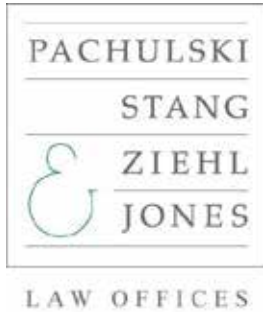


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6. On the morning of July 31, 2020, I intended to prepare a summary for the Committee of the status of my negotiations with Kamensky regarding the cash-out option and the remaining issues to be negotiated. Prior to my doing so, the Committee's financial advisor, Mohsin Meghji of M-III Partners L.P. ("Meghji"), sent me an e-mail that Jefferies LLC ("Jefferies") had contacted him to inquire about Jefferies providing an unsolicited bid in the range of \$0.30+ per Series B Share for the purchase of the entire 140 million Series B Shares or, alternatively, a cash-out option for those unsecured creditors who wanted it. Meghji and I concluded that we should have an immediate call with Jefferies to discuss their higher cash-out option proposal.

7. At 9:15 a.m. Pacific time on July 31, 2020, Meghji and I had a telephone conference with Eric Geller ("Geller") and another gentleman from Jefferies. We advised Geller and his colleague that we seriously doubted there would be any interest in selling the full 140 million Series B Shares at a discount because many unsecured creditors preferred their allocation of the Series B Shares, but the Committee would be very interested in the cash-out option. Meghji and I answered many of Geller's and his colleague's questions and, at the conclusion of the call, Geller informed us that Jefferies intended to provide Meghji and me an offer by end of the day on July 31, 2020. About the time of our call with Jefferies, Kamensky had reached out to me to get an update, as we all had a goal to complete any cash-out option structure by Monday, August 3, 2020, the Plan solicitation date, if at all possible.

8. At 12:15 p.m. Pacific Time on July 31, 2020, Meghji and I spoke to Kamensky. We informed Kamensky of the Jefferies inquiry. We further informed him that we did not believe it was appropriate to complete any negotiation with Marble Ridge until we determined if Jefferies would actually make an offer and, if Jefferies did make such an offer, we would need to speak to the Committee about next steps. Kamensky responded that, based on his trading experience, he thought Jefferies was just fishing for information and would not actually make a bid.



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9. Just after 1:00 p.m. Pacific Time on July 31, 2020, Geller sent Meghji and me an e-mail that he wanted us to call him. I reached Geller and his colleague at approximately 2:00 p.m. Pacific Time. Geller and his colleague advised me that Jefferies would not be providing a proposal or a cash-out offer because a significant client of Jefferies had insisted that Jefferies stand down. They also advised me that Jefferies' General Counsel had advised them to be completely transparent with the Committee. I asked Geller and his colleague if the significant client of Jefferies was a member of the Committee and Geller said "yes". I then asked, if the Committee Member was Kamensky and Geller said "yes". The call then ended. I contacted Meghji to inform him of my call with Geller and his colleague. Meghji and I then set up a call with our respective professional teams to discuss next steps.
10. Meghji informed us during our professionals call that he also spoke to Geller, subsequent to my call with Geller, and that Geller confirmed that Jefferies was told by Kamensky to stand down; but Geller did add that while Jefferies was not moving forward with an offer for a cash-out option, certain parties Jefferies was intending to partner with may still be interested in making an offer.
11. At approximately 4:00 p.m. Pacific Time, on July 31, 2020, a group of the Committee's professionals contacted Ed Weisfelner ("Weisfelner"), Marble Ridge's counsel, to ask what he knew, if anything, about Kamensky approaching Jefferies to stand down. Weisfelner said he knew nothing about the Jefferies situation, and would call us back after he reached Kamensky. Approximately 30 minutes later, I and other Committee professionals spoke again with Weisfelner who informed us that Kamensky said he did contact Jefferies, but there was a *misunderstanding*; specifically, that Kamensky told Jefferies that they should bid if they were serious but, if not, they should back off to avoid disrupting the process.
12. On the morning of August 1, 2020, Geller and one of his colleagues contacted me to inquire whether the Committee would be interested in receiving an offer for a cash-out



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option for the unsecured creditors. I said “yes”. I then asked if Geller would re-confirm the conversation that he and I had the day before with regard to Kamensky asking Jefferies to stand down. Geller re-confirmed the conversation and the statements made. At the end of the conversation, Geller said Jefferies would have an offer to the Committee for the cash-out option by mid-day Monday, August 3, 2020. I asked Geller and his colleague if Kamensky called them and told them they should move forward with their bid. Geller said the Jefferies General Counsel did not want them to discuss with me anything beyond what they conveyed the day before. I said I understood and I then requested they have the General Counsel reach out to me, which he did, and we ultimately scheduled a call among some of the Committee professionals with the Jefferies’ General Counsel for the afternoon of August 1, 2020.

13. Late morning on August 1, 2020, the Committee held a meeting where the Committee was informed that Marble Ridge’s counsel had already advised you that Marble Ridge resigned its position on the Committee (*see* Weisfelner’s e-mail of August 1, 2020, to you, a copy of which was provided to me), and of the above developments and the intended next steps. In particular, the professionals informed the Committee that:
 - a. Michael Warner and I would immediately contact you regarding these issues (our call to you August 1, 2020, in the afternoon); and
 - b. We were hopeful that Jefferies would make a cash-out offer for the benefit of interested unsecured creditors by mid-day Monday, August 3, 2020 (as speed was important, both for the Plan process and the disclosures required to the Court) and, if so, that the Committee professionals would work expeditiously to finalize a potential *stalking horse* agreement with Jefferies if the offer was acceptable to the Committee and, immediately thereafter, file a motion to approve an auction procedure for the cash-out option that would, among other things, disclose the above situation. The disclosure of the issues



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above would be included for full disclosure and avoid any tainting of the process in an effort to maximize recovery for unsecured creditors.

14. As discussed in our call with you yesterday, August 1, 2020, the expectation is that the motion regarding the cash-out option would be filed sometime during the middle of this week. We also advised you that, if no such motion were likely to be filed this week for whatever reason, we would consider a different mechanism to advise the Court of the above situation. As discussed, we fully intend to inform the Court about the relevant facts and will not let the process dictate or delay such disclosure.
15. In the afternoon on August 1, 2020, following our call with you, a group of the Committee's professionals spoke to Jefferies' General Counsel. Among other things, the General Counsel informed us that Kamensky contacted Jefferies again (following the initial call earlier in the day) on Friday evening (July 31, 2020) and that the General Counsel was not on that call, but he had been told by Jefferies' employees, that Kamensky *seemed concerned*. We were told no further information regarding the change in position. We did say that the Committee was pleased to hear that Jefferies would be making a proposal.

Thank you again for taking the time yesterday to speak to Michael Warner and me. As we informed you, because of the sensitivity of the facts and circumstances laid out above, we have not advised anyone of this situation, except for the Committee. We are still processing the information in order to maximize, and not jeopardize, value for unsecured creditors, as well as addressing the integrity of the entire bankruptcy process. As we discussed with you, we will look to you for your input on the method and timing to bring these issues to the Court's attention.

AMERICAN BANKRUPTCY INSTITUTE

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We look forward to speaking to you after the weekend and will continue on the path I have set forth above, but will not formalize any agreement with Jefferies or file anything with the Court until we have spoken to you further. Michael Warner and I will make ourselves available at your convenience to speak to you or others in the United States Trustee's Office to discuss this matter.

Very truly yours,

/s/

Richard M. Pachulski

Via E-mail

cc: Mo Meghji
Alan Kornfeld, Esq.
Jeff Pomerantz, Esq.
Michael D. Warner, Esq.
Maxim Litvak, Esq.

EXHIBIT 3

UNITED STATES DEPARTMENT OF JUSTICE
OFFICE OF THE UNITED STATES TRUSTEE
HENRY G. HOBBS, JR.
ACTING UNITED STATES TRUSTEE
REGION 7, SOUTHERN and WESTERN DISTRICTS OF TEXAS
HECTOR DURAN
TRIAL ATTORNEY
515 Rusk, Suite 3516
Houston, Texas 77002
Telephone: (713) 718-4650 x 241
Fax: (713) 718-4670

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE: § CASE NO.
§
NEIMAN MARCUS GROUP LTD, LLC, § 20-32519 (DRJ)
et al., § (Chapter 11)
§ Jointly Administered
DEBTORS¹ §

STATEMENT OF THE ACTING UNITED STATES TRUSTEE
PURSUANT TO COURT ORDER REGARDING THE CONDUCT
OF MARBLE RIDGE CAPITAL LP AND DAN KAMENSKY

TO THE HONORABLE DAVID R. JONES
UNITED STATES BANKRUPTCY JUDGE:

¹ The Debtors in these chapter 11 cases, along with the last four digits of each Debtor’s federal tax identification number, are: Neiman Marcus Group LTD LLC (9435); Bergdorf Goodman Inc. (5530); Bergdorf Graphics, Inc. (9271); BG Productions, Inc. (3650); Mariposa Borrower, Inc. (9015); Mariposa Intermediate Holdings LLC (5829); NEMA Beverage Corporation (3412); NEMA Beverage Holding Corporation (9264); NEMA Beverage Parent Corporation (9262); NM Bermuda, LLC (2943); NM Financial Services, Inc. (2446); NM Nevada Trust (3700); NMG California Salon LLC (9242); NMG Florida Salon LLC (9269); NMG Global Mobility, Inc. (0664); NMG Notes PropCo LLC (1102); NMG Salon Holdings LLC (5236); NMG Salons LLC (1570); NMG Term Loan PropCo LLC (0786); NMG Texas Salon LLC (0318); NMGP, LLC (1558); The Neiman Marcus Group LLC (9509); The NMG Subsidiary LLC (6074); and Worth Avenue Leasing Company (5996). The Debtors’ service address is: One Marcus Square, 1618 Main Street, Dallas, Texas 75201.

COMES NOW the Acting United States Trustee for Region 7 (the “United States Trustee”), by and through the undersigned counsel, who respectfully submits this statement in response to the Court’s order of August 5, 2020 [Dkt. No. 1442] (the “Order”), and represents as follows:

PRELIMINARY STATEMENT AND SUMMARY

This statement sets out the evidence gathered by the United States Trustee and his preliminary analysis pursuant to the Court’s order directing a statement of position “regarding the conduct of Marble Ridge and Mr. Kamensky in this case.” Dkt. No. 1442. Marble Ridge Capital LP (“Marble Ridge”) was until recently one of the three co-chairs of the Official Committee of Unsecured Creditors (the “Committee”) appointed in the jointly administered chapter 11 cases of the Neiman Marcus Group (the “Debtors”), and Dan Kamensky, the managing partner and principal of Marble Ridge, served as Marble Ridge’s representative on the Committee. The Court’s Order expressed concern over “alarming” allegations about the conduct of Marble Ridge and Mr. Kamensky and ordered the United States Trustee to review the allegations and file this statement within fourteen days of the Order. *Id.*

Based on the United States Trustee’s time-limited investigation, on July 31, Marble Ridge, through Mr. Kamensky, breached its fiduciary duty of loyalty to the creditors it represented by coercing an outside investor to refrain from bidding against Marble Ridge on a key transaction that was considered integral to a successful plan of reorganization.² Furthermore, Marble Ridge’s initial explanation of its own actions to the Court and to the United States Trustee was, at best,

² Nevertheless, after initially refusing to bid, the outside investor ultimately made a competing offer for the assets once information about Marble Ridge’s conduct became the subject of this investigation.

incomplete and misleading. Based on these facts, further proceedings before the Court may be appropriate to permit the Court to hear from the witnesses and receive evidence concerning Marble Ridge and Mr. Kamensky and to consider what remedial measures, if any, are appropriate.³

I. SCOPE AND LIMITATIONS OF UNITED STATES TRUSTEE'S INVESTIGATION

Immediately following the August 5 Order, the United States Trustee prepared requests for documents and interviews to individuals who appeared to have knowledge relating to the allegations against Marble Ridge and Mr. Kamensky.⁴ The United States Trustee sent document requests to: (i) Richard Pachulski, counsel to the Committee; (ii) Michael Warner, co-counsel to the Committee; (iii) Moshin Meghji, financial advisor to the Committee; (iv) Eric Geller, of Jefferies Financial Group, Inc. (“Jefferies”); (v) Mr. Kamensky; (vi) Edward Weisfelner, counsel to Marble Ridge; and (vii) Chad J. Husnick and Anup Sathy, counsel to the Debtors. These requests sought:

documents and media of any kind pertaining to the potential purchase or conversion to cash of MYT Series B Preferred Shares held or to be held by the unsecured creditors of the debtors Neiman Marcus Group LTD LLC, et al. and/or any potential conflict of interest arising therefrom.

The United States Trustee directed the requests both to the individuals as well as to their respective companies and requested responses by August 10. The United States Trustee also requested a

³ Because of the preliminary and non-adversarial nature of the United States Trustee’s investigation, the United States Trustee does not comment on the availability or viability of any causes of action that might be asserted by particular parties in this case.

⁴ The United States Trustee, in coordination with the Executive Office for United States Trustees, assembled a team to undertake this investigation that, in addition to the undersigned, included, among others, a former Assistant United States Attorney.

litigation hold on responsive documents. Although in many cases documents were not produced until after the August 10 deadline, the United States Trustee nevertheless received and reviewed approximately 3,200 pages of documents.

Between August 14 and August 17, the United States Trustee also conducted voluntary individual interviews via videoconference with Mr. Pachulski, Mr. Meghji, and Mr. Kamensky. In place of Mr. Geller, the United States Trustee interviewed a different Jefferies employee who requested that his name be kept anonymous in this report as a condition of his voluntary interview and cooperation. The United States Trustee agreed to this condition with respect to this statement only, and this individual will accordingly be referred to as “Jefferies Employee No. 1” or “JE1” in this statement. Mr. Weisfelner also made a presentation to the United States Trustee that sought to explain the background of Marble Ridge’s involvement with the Debtors and these cases. Each interview lasted between ninety minutes and four hours. Except in the case of Mr. Weisfelner’s presentation, a court reporter transcribed all interviews, and all witnesses were accompanied by counsel and agreed to be sworn.

This investigation was conducted on a fully voluntary basis, and the United States Trustee commends each of the persons or firms interviewed or providing documents for their cooperation. Because the United States Trustee’s investigation was not ordered under Rule 2004, the United States Trustee did not have the power to compel testimony or production of documents. Although the understandable, but short, deadline for submission of this statement somewhat constrained the United States Trustee’s work, this statement nevertheless renders sufficient evidence for the Court and the parties to determine appropriate next steps. Due to these time constraints, the United States

Trustee was unable to provide any of the parties with an opportunity to review or respond to this statement prior to its submission to the Court.⁵

II. STATEMENT OF FACTS

A. Pre-Petition Background

Marble Ridge is the holder of certain of Neiman Marcus's debt and characterizes itself as the largest single unsecured creditor of the Debtors as of the petition date. Since 2018, Marble Ridge and the Debtors have been engaged in a protracted legal dispute involving the Debtors' interests in MyTheresa, an e-commerce retailer, which were transferred to the Debtors' (non-debtor) parent in 2018 as an equity distribution (the "MyTheresa Distribution"). This transaction, which Marble Ridge has characterized as a fraudulent transfer, was the subject of two state court actions filed before the petition date, one by Marble Ridge and another by an Indenture Trustee allegedly on Marble Ridge's behalf.

In 2019, Neiman Marcus entered into a recapitalization agreement that had the effect of resolving potential claims arising out of the MyTheresa Distribution with many of its creditors—though not with Marble Ridge, which declined to participate in the exchange. Of significance here, those negotiations also created a "waterfall" that governed how the proceeds of MyTheresa would be distributed in the event of a sale or other monetization. Under that waterfall, the first \$450 million of any sale would go to certain secured lenders and to the holders of Series A preferred stock in the holding company for the MyTheresa assets, while the next \$250 million would go to the holders of Series B preferred stock, which was initially distributed to a Neiman

⁵ For the same reasons, the United States Trustee was unable to cite specifically to documents and transcripts in this statement.

Marcus affiliate (the “Series B Shares”). The Series B Shares were apparently designed to represent an indirect source of recovery for Neiman Marcus’s owners in the event of a MyTheresa sale; they were also highly illiquid, because they would be payable only in the event of a sale or monetization and even then only if the amount realized was at least \$450 million.

On April 28, Neiman Marcus appointed Marc Beilinson⁶ and Scott Vogel as “disinterested managers” to its Board of Managers (the “Disinterested Managers”). The Disinterested Managers were charged with determining “whether a conflict exists with respect to any issue in connection with the Debtors’ chapter 11 cases,” as well as with investigating the MyTheresa Distribution.

B. Commencement of the Bankruptcy Case and the Appointment of the Committee.

On May 7, the Debtors filed voluntary petitions seeking relief under chapter 11 of the Bankruptcy Code. That same day, the United States Trustee sent out a standard questionnaire to the Debtors’ largest creditors in order to solicit interest in serving on the Committee. Among other things, that questionnaire informed prospective committee members that they would be required to act as “fiduciaries who represent all unsecured creditors as a group.”

On May 10, Marble Ridge, through its general counsel, submitted a completed questionnaire expressing its willingness to serve on the Committee. In its cover email, Marble Ridge stated that:

If appointed to the Committee, Marble Ridge would be represented by Dan Kamensky. Mr. Kamensky has more than 20 years of bankruptcy and investing experience and fully understands the fiduciary responsibilities associated with membership on the Committee. Mr. Kamensky is committed to devote the time and energy necessary to earnestly represent all unsecured creditors.

⁶ Mr. Beilinson resigned his position in June after a health emergency.

On May 19, the United States Trustee appointed a nine-member Committee that included Marble Ridge. Dkt. No. 455. Marble Ridge would subsequently be elected as one of three co-chairs of the Committee, which retained the law firms of Pachulski, Stang, Ziehl & Jones and Cole Schotz P.C. as its counsel, and M-III Advisory Partners L.P. as its financial advisor. Dkt. Nos. 1105, 1106, 1225.

C. The Examiner Motion and Motion to Terminate Exclusivity.

The dispute over the MyTheresa Distribution would play a prominent role in many of the contested matters that would be brought before the Court in the first months of these cases. On May 15, Marble Ridge filed the Expedited Motion to Appoint an Examiner, which sought appointment of an examiner under section 1104 of the Bankruptcy Code to investigate the MyTheresa Distribution (the “Examiner Motion”). Dkt. No. 424. The Committee supported the Examiner Motion, but the Debtors, the Disinterested Managers, and certain groups of ad hoc lenders opposed it. Following a hearing before the Court on May 29, Marble Ridge withdrew the Examiner Motion without prejudice. Dkt. No. 664.

On June 21, the Committee filed a motion to terminate exclusivity, which sought permission to file a plan substantially identical to the proposed plan filed by the Debtors, except that it would eliminate certain releases and preserve causes of action relating to the MyTheresa Distribution. Dkt. No. 1061.

Although the litigation positions of the Committee during the first months of the case were closely aligned with those of Marble Ridge, there is no evidence that this was because of any improper influence exercised by Marble Ridge on the other Committee members. Rather, Mr. Pachulski, Committee counsel, characterized the Committee as “great to work with” until the Marble Ridge-Jefferies issues arose on July 31. Mr. Pachulski noted that the Committee was

populated by a diverse group of experienced and highly sophisticated creditors in addition to Marble Ridge and characterized that diversity as a “good thing.”

D. Marble Ridge Submits an Offer to Purchase Estate Litigation Claims

On the morning of July 4, Mr. Kamensky told Mr. Pachulski that Marble Ridge would be willing to submit an offer to purchase the MyTheresa-related litigation claims from the Debtors’ estate. Mr. Kamensky raised this suggestion again on July 9, during a call between the Committee co-chairs, the Committee professionals, and Mr. Vogel. Mr. Pachulski advised Mr. Kamensky that he thought the offer would be premature given the state of negotiations but informed the rest of the Committee of Mr. Kamensky’s expression of interest at some point between July 11 and July 14. Mr. Pachulski stated his belief that Mr. Kamensky’s offer was designed either to obtain a fair settlement or to increase the chances of obtaining a plan with a settlement trust. He said that Mr. Kamensky had “zero interest” in actually buying the litigation claims.

On July 24, Mr. Kamensky, on behalf of Marble Ridge, submitted an offer to Mr. Vogel for the purchase of the Debtors’ MyTheresa-related litigation claims. At a Committee meeting that same day, Mr. Pachulski, who was not informed in advance of Marble Ridge’s offer, informed Mr. Kamensky that he had two options: he could either withdraw his offer and agree not to submit any other offer without prior Committee approval, or if he chose not to withdraw his offer, he would be recused from Committee discussions regarding a settlement. Mr. Kamensky chose to withdraw his offer. Neither the United States Trustee nor the Court was informed of Mr. Kamensky’s initial expression of interest, his offer to purchase the claims, or the withdrawal of his offer until after the events of July 31.

E. Marble Ridge Proposes to Fund a Cash Out Option for the Series B Shares

In late July, the parties made progress towards a global settlement of the MyTheresa disputes, which ultimately would be announced to the Court at the disclosure statement hearing of July 30. Because it was probable that any settlement would likely involve the transfer of the Series B Shares that Neiman Marcus's parent had retained, Mr. Pachulski began to explore alternatives for a "cash out" option, under which creditors could exchange the illiquid Series B Shares for cash. Mr. Pachulski believed that this was particularly important for the Debtors' trade creditors, who strongly prefer cash to securities, and he believed a cash out option would help pave the way for a consensual plan of reorganization.

On July 28, following discussions with Mr. Pachulski, Mr. Kamensky emailed the outline of a cash out proposal to the Committee's members and professionals. The most salient feature of this rough proposal was that Marble Ridge would guarantee, or "backstop," the purchase of 60 million Series B Shares at twenty cents per share from other unsecured creditors wishing to sell. Other noteholder creditors would have the right to participate in the purchase of the 60 million shares in proportion to their pro rata share of the overall noteholder group of claims. Marble Ridge would purchase the shares available to any noteholder that did not wish to participate.

At a meeting held on July 29, the Committee members voted to support the global settlement. Mr. Pachulski excused Marble Ridge from the meeting, and the members discussed the outline of the cash out proposal. While not affirmatively accepting Mr. Kamensky's proposal, the Committee agreed to continue negotiations with Marble Ridge. These negotiations appear to have been somewhat time-sensitive, since any last-minute changes to the Disclosure Statement would need to be presented to the Court at a hearing set for August 3, in order to be included in the Disclosure Statement mailed to creditors.

F. Events of July 30 and 31**1. *The Jefferies Proposal***

Even as the Committee worked on the Marble Ridge proposal, the financial firm Jefferies was considering its own cash out offer. Eric Geller is the senior analyst in the Jefferies Distressed and Special Situations section. The Distressed and Special Situations section in Jefferies trades on its own behalf and for clients, one of whom is Marble Ridge.⁷ On the evening of July 30, Mr. Geller learned of the amended Neiman Marcus plan of reorganization providing for the distribution of the Series B Shares to unsecured creditors. That same evening, another Jefferies client contacted Mr. Geller to express interest in purchasing the Series B Shares. Mr. Geller then sent texts around 9:00 PM ET to JE1 and another Jefferies employee to discuss the possibility of making an offer to buy the Series B Shares.

JE1 saw these texts the next morning on July 31, and talked to Mr. Geller at approximately 8:00 AM ET. At 8:10 AM ET, JE1 and Mr. Geller had a call with the Jefferies client. The client expressed an interest in purchasing through Jefferies 70 million of the 140 million Series B Shares set to be distributed. After the call with the Jefferies client, JE1 spoke with an additional client who indicated interest in purchasing 10 million Series B Shares. At that point, JE1 believed there was more than enough interest for Jefferies to move forward with a proposal to buy Series B Shares.

Between 9:00 AM ET and 10:00 AM ET on July 31, Mr. Geller called Mr. Meghji, the Committee's financial advisor. Mr. Geller informed Mr. Meghji that Jefferies was interested in

⁷ Mr. Kamensky later informed the United States Trustee that Jefferies was Marble Ridge's ninth largest trading partner and that Marble Ridge had paid Jefferies approximately \$200,000 in trading commissions during the first six months of 2020.

making a bid to purchase the 140 million Series B Shares set to be distributed to unsecured creditors as part of the amended plan of reorganization. He informed Mr. Meghji that the firm was considering offering to buy the shares for a price in the range in “the thirties”—in other words, between thirty and forty cents per share. Mr. Geller sent Mr. Meghji a follow up email at 10:22 AM ET confirming Jefferies’s interest in submitting a firm bid to purchase the shares and its capacity to complete the transaction if the Committee chose to accept a bid from Jefferies. Mr. Geller’s email requested that Mr. Meghji keep Jefferies’s bid confidential from any member of the Committee that was interested in making its own cash out offer for the Series B Shares.

After speaking with Mr. Geller, Mr. Meghji contacted Mr. Pachulski. Mr. Meghji and Mr. Pachulski decided the next necessary step was to schedule a further call with Jefferies to gauge the firm’s interest in the shares and the potential for a Jefferies bid to produce a higher return for unsecured creditors than the pending offer from Marble Ridge. At 12:15 PM ET, Mr. Meghji and Mr. Pachulski spoke with Mr. Geller and JE1. Mr. Pachulski explained that while Jefferies could make a bid for the 140 million shares as a block, some unsecured creditors wanted to keep their shares, so an offer that allowed creditors to opt in or out of the sale would be more likely to be successful. Mr. Geller and JE1 had no issue proceeding along those lines and confirmed a price in the “thirties.” They also indicated that Jefferies was prepared to submit a proposal by the end of the day.

After the 12:15 PM ET call with the Committee professionals, JE1 began putting together a formal bid to buy Series B Shares from those unsecured creditors who wished to sell them. He informed internal Jefferies legal counsel of the proposed offer, and Jefferies outside legal counsel was tasked to prepare documents for the bid. JE1 discussed the Series B proposal with senior Jefferies management.

Mr. Pachulski and Mr. Meghji came away from the 12:15 PM ET conversation satisfied Jefferies was serious about making a cash out offer for the Series B Shares. They determined they would need to halt work on finalizing the Marble Ridge proposal to allow consideration of a proposal from Jefferies. They decided they needed to inform Mr. Kamensky of this development.

2. *Mr. Kamensky Learns of the Jefferies's Proposal and Forces its Withdrawal*

At 3:15 PM ET, Mr. Pachulski and Mr. Meghji called Mr. Kamensky. They informed him that another possible bidder had come forward to discuss making a cash out offer on the Series B Shares. They informed him the possible price for this bid was in the range of \$0.30 per share. When Mr. Kamensky asked them who the new potential purchaser was, they informed him that it was Jefferies. Mr. Pachulski stated that he did not recall Jefferies's request to keep its potential bid confidential, and it may be that this request was made only to Mr. Meghji. In any event, according to both Mr. Pachulski and Mr. Meghji, Mr. Kamensky received this news calmly, without apparent anger or surprise. Mr. Kamensky stated that he believed the Jefferies's expression of interest was not serious and that nothing would come of it; he stated that Jefferies was likely just fishing for information.

Despite Mr. Kamensky's calm demeanor during his 3:15 PM ET call with Mr. Pachulski and Mr. Meghji, Mr. Kamensky engaged in a frenzy of activity once it concluded. Immediately thereafter, Mr. Kamensky via Instant Bloomberg chat told Christopher Bauer, Head Trader at Marble Ridge, to check his text messages on his iPhone. At 3:20 PM ET, Mr. Bauer received a text message from Mr. Kamensky on his iPhone, which started the text message exchange set out below:

Fri. Jul 31 3:20 PM

Kamensky: Eric Geller from Jefferies called the UCC counsel and offered to buy the units at 30 cents, that is a monumental mistake. I'm getting [JE1] now. he needs to talk me. let me know. They are threatening to put a bid in.

Bauer: For nmg??

Kamensky: yes i just texted [JE1]

Bauer: Yikes what did we bid. Those guys man I hope they were just ignorant to our interests

Consistent with the text exchange between Mr. Kamensky and Mr. Bauer, Mr. Kamensky began communicating with JE1 at 3:20 PM ET using Instant Bloomberg chat messages. Mr. Kamensky told JE1 not to put in a proposal for the Series B Shares. The message chain between Mr. Kamensky and JE1 starting at 3:20 PM ET and ending at 3:28 PM ET is set out in relevant part below:

(2020-07-31 03:20:13 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL) has invited [JE1] (JEFFERIES LLC)

Need you NOW

(2020-07-31 03:20:40 PM EDT)

[JE1] (JEFFERIES LLC)

Call me in 10min

(2020-07-31 03:20:52 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL)

Tell Geller to stand DOWN

(2020-07-31 03:20:55 PM EDT)

[JE1] (JEFFERIES LLC)

Im on an inernal call

(2020-07-31 03:20:55 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL)

And let's talk

(2020-07-31 03:20:59 PM EDT)

[JE1] (JEFFERIES LLC)

I can't get off of

(2020-07-31 03:21 :03 PM EDT)

[JE1] (JEFFERIES LLC)

Lets speak in 10 min pls

(2020-07-31 03:21 :28 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL)

Do I need to reach out to Geller

(2020-07-31 03:28:30 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL)

DO NOT SEND IN A BID

Mr. Kamensky also contacted Mr. Geller at 3:23 PM ET by Instant Bloomberg and asked to speak right away:

(2020-07-31 03:23:55 PM EDT) DKAMENSKY2 (MARBLE RIDGE CAPITAL) has invited EGELLER9 (JEFFERIES LLC)

What is your number? Need you now?

Mr. Kamensky later stated to the United States Trustee that his instant messages to Mr. Geller and JE1 were motivated by panic. He feared Jefferies's bid might jeopardize an agreement on a cash out proposal for the Series B Shares. Mr. Kamensky claimed that, in his call with Mr. Pachulski and Mr. Meghji, Mr. Pachulski had said words to the effect of "that would be a problem" in response to Mr. Kamensky saying Jefferies was not a serious bidder. Mr. Kamensky said he interpreted this to mean that Jefferies's potential bid might disrupt the process of including a cash out proposal in the Disclosure Statement and Plan by August 3, which he understood to be a firm deadline. He admitted that he did not further discuss this concern with Mr. Pachulski. Mr. Kamensky also conceded a fear that Jefferies's higher price for the shares, mentioned in his texts with Mr. Bauer, would hurt Marble Ridge's ability to profit from any Series B purchase. He nevertheless claimed that process concerns about endangering the agreement on a cash out provision were his primary motivation for contacting JE1 and Mr. Geller. Mr. Kamensky admitted that contacting and trying to influence a potential rival bidder for property of the bankruptcy estate was wholly inappropriate and a grave mistake. He stated he should have gone to Mr. Pachulski with his concerns about the effect of Jefferies on the cash out process and let Mr. Pachulski make any necessary inquiries.

Following Mr. Kamensky's chat messages, JE1 and Mr. Geller spoke with Mr. Kamensky on the phone at approximately 3:45 PM ET. According to JE1, Mr. Kamensky was very upset and told them to stand down and not put in a bid. JE1 responded that Jefferies was just engaging in its normal business of purchasing assets. Mr. Kamensky told them that they did not understand how deep his interest was in the Series B Shares. He said he had been pursuing this matter for several years and amassed \$3.5 million in legal fees. His efforts had made the MyTheresa settlement possible. He said he was determined to acquire the shares, so all that Jefferies's bid would accomplish was driving up his final price and costing him money. He said that as co-chair of the Committee, he would prevent Jefferies from acquiring the shares. Finally, Mr. Kamensky stated that he had been a good partner to JE1 and Jefferies, but if JE1 moved forward with the Series B bid, they would not be partners going forward. JE1 understood this last statement as Mr. Kamensky using a possible termination of the business relationship between Marble Ridge and JE1's section of Jefferies to pressure JE1 to drop the bid. JE1 ended the conversation with Mr. Kamensky by stating they would consider what to do and get back to him.

In his interview with the United States Trustee, Mr. Kamensky admitted that he made each of the coercive statements recounted by JE1, including the promise to use his position as Committee Co-Chair to prevent the Jefferies's bid from winning and the statement that Marble Ridge would end its business relationship with Jefferies if the bid went forward. As Mr. Kamensky remembered it, Mr. Geller at the start of the call said Jefferies was just pursuing its normal business of pursuing bankruptcy assets and wanted to buy half the Series B shares. According to Mr. Kamensky, this remark turned his panic into fury. He said he perceived Jefferies to be shaking him down for half the available assets by barging into a situation they knew nothing about at a sensitive time. Mr. Kamensky said he began to shout, curse, and demand that Jefferies stand down

on any bid, while making the coercive statements recounted by JE1. Mr. Kamensky admitted to the United States Trustee that these statements were entirely inappropriate.

According to Mr. Kamensky, JE1 then asked him why he was so angry. Mr. Kamensky said this led him to regain his composure, and the latter half of the call purportedly involved a calmer discussion of Mr. Kamensky's long history with Neiman Marcus and the complications involved with the Series B Shares.⁸ Mr. Kamensky stated to the United States Trustee that he believed at the end of the call JE1 and Mr. Geller would consider Jefferies's next steps in light of the information he provided in the "calm" latter half of the call, not the coercive statements he made in the "angry" first half of the call. Mr. Kamensky claimed that the intended message of the "calm" half of the call was that Jefferies should bid if it was a serious bidder but that it should back off if it was not serious to avoid disruption to the bankruptcy process. He admitted, however, that he never actually said to JE1 and Mr. Geller that Jefferies should bid if it was serious or refrain from bidding if it was not.

JE1 and Mr. Geller had no perception that any portion of their call with Mr. Kamensky had superseded his demands that Jefferies pull its bid or face the consequences. JE1 specifically denied Mr. Kamensky ever gave them any indication that all he wanted was for Jefferies to bid if it was serious. JE1 and Mr. Geller perceived a clear and singular message: Jefferies should withdraw its bid or Mr. Kamensky would exact consequences by terminating their relationship.

Immediately after the call, JE1 spoke with Mr. Geller about his discomfort with what had just happened. JE1 believed that Mr. Kamensky's actions were outside the bounds of normal

⁸ Because Mr. Kamensky was interviewed after JE1, the United States Trustee was unable to ask JE1 about the "calmer" portion of the conversation recounted by Mr. Kamensky.

trading behavior. He also believed that Mr. Kamensky was abusing his position as a fiduciary in the bankruptcy case. Furthermore, Mr. Kamensky's demand that Jefferies not bid might involve JE1 and Jefferies in unethical and even illegal conduct. At the same time, JE1 was concerned about his business relationship with Mr. Kamensky and Marble Ridge. JE1 decided to speak with Jefferies general counsel, Mike Sharp, about the situation and called him at approximately 3:55 PM ET.

JE1's discussion with Jefferies general counsel resulted in a two-part decision: (1) Jefferies would withdraw from making any bid to purchase the Series B Shares; (2) JE1 and Jefferies would be completely transparent with all interested parties about why it was withdrawing. JE1 and Mr. Geller called Mr. Kamensky at approximately 4:07 PM ET. JE1 explained that Mr. Kamensky was an important relationship, and Jefferies would withdraw from making any bid for the Series B Shares. Jefferies, however, would also be transparent about why it was withdrawing. Specifically, Jefferies would be transparent about its reason for withdrawing with both its client who sought to purchase the shares and with the advisors for the Committee. Mr. Kamensky responded by thanking JE1 and Mr. Geller and saying he would always be grateful to them. After the call, Mr. Geller remarked to JE1 that Mr. Kamensky appeared not to hear or understand JE1's statement that they would be transparent about their reasons for withdrawing. Mr. Kamensky later confirmed to the United States Trustee that he did not hear the statement about being transparent on what led them to withdraw.

At 4:08 PM ET, during or immediately after his call with JE1 and Mr. Geller about the withdrawal, Mr. Kamensky contacted Mr. Bauer by Instant Bloomberg chat to share the news:

(2020-07-31 04:08:10 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL)

They are standing down

(2020-07-31 04:08:13 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL)

See me

(2020-07-31 04:08:15 PM EDT)

CCBAUER13 (MARBLE RIDGE CAPITAL)

Yeah

(2020-07-31 04:08:19 PM EDT)

CCBAUER13 (MARBLE RIDGE CAPITAL)

Thank goodness

(2020-07-31 04:08:22 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL)

He took the high roadf

(2020-07-31 04:08:28 PM EDT)

DKAMENSKY2 (MARBLE RIDGE CAPITAL)

Thank gd

(2020-07-31 04:08:52 PM EDT)

CCBAUER13 (MARBLE RIDGE CAPITAL)

He got the call from H

(2020-07-31 04:08:56 PM EDT)

CCBAUER13 (MARBLE RIDGE CAPITAL)

"stand down!!"

Shortly after their 4:07 PM ET call with Mr. Kamensky, JE1 and Mr. Geller contacted their original client for the purchase of the Series B Shares and told him they were withdrawing from making a bid. They explained they were withdrawing because of pressure from another client. JE1 and Mr. Geller then tried to contact Mr. Pachulski and Mr. Meghji. After an initial attempt to reach them by phone, Mr. Geller sent an email at 4:13 PM ET to Mr. Pachulski and Mr. Meghji requesting they call him back.

3. *The Committee Learns of Mr. Kamensky's Actions*

Mr. Pachulski alone eventually talked with JE1 and Mr. Geller at approximately 5:00 PM ET. After Mr. Geller explained that Jefferies was withdrawing from making a bid, Mr. Pachulski asked why. Mr. Geller explained that Jefferies was withdrawing because a significant client had asked it to do so. Mr. Pachulski asked if that client was a member of the Committee. Mr. Geller said yes. Mr. Pachulski asked if the client was Mr. Kamensky. Mr. Geller said yes. According to JE1, Mr. Pachulski responded by saying, "I've got a big problem." After the call concluded, Mr. Pachulski informed Mr. Meghji of Jefferies's withdrawal and its stated reason for doing so. Mr. Pachulski set a 6:00 PM ET conference call for Committee professionals to decide on the necessary steps in reaction to Mr. Kamensky's reported actions. In the meantime, Mr. Meghji conducted his

own follow up call with Mr. Geller, who confirmed the basic account he had provided Mr. Pachulski about Jefferies's withdrawal.

At the 6:00 PM ET conference call, the Committee professionals decided as a first step to reach out to Mr. Weisfelner, counsel for Marble Ridge, to determine if Jefferies's report about Mr. Kamensky's conduct was accurate. At approximately 7:00 PM ET, Mr. Pachulski and several other Committee professionals spoke to Mr. Weisfelner. Mr. Weisfelner responded that he knew nothing about the allegations and would call them back after contacting Mr. Kamensky. Mr. Kamensky confirmed to the United States Trustee that Mr. Weisfelner called him at this time and informed him that Jefferies had reported to Committee counsel that it was withdrawing from bidding after pressure from Mr. Kamensky. Mr. Weisfelner spoke again with Mr. Pachulski and other Committee professionals at approximately 7:30 PM ET. After speaking with Mr. Kamensky, he reported that Mr. Kamensky did contact Jefferies about its potential bid, but there was a misunderstanding about his intention in doing so. According to Mr. Weisfelner, Mr. Kamensky had told Jefferies to bid if it was serious. If it was not serious, it should back off to avoid disruption to the Neiman Marcus bankruptcy. Mr. Pachulski ended the call by stating that he would need to schedule an emergency meeting of the Committee without Marble Ridge or its attorneys to consider the Committee's next steps.

Meanwhile, Mr. Kamensky was trying to contact JE1. At 7:42 PM ET, he sent an Instant Bloomberg chat message to JE1 asking "Are you there?" JE1 got the messages and reported being available at 8:08 PM ET. Mr. Kamensky and JE1 soon thereafter began a phone conversation. According to JE1, Mr. Kamensky began the call by saying, "this conversation never happened." Disturbed by this opening, JE1 began to record the phone call. Through counsel, JE1 later voluntarily provided a copy of the recorded call, an initial rough transcript, and then a final

transcript to the United States Trustee. In the recorded portion of the call, Mr. Kamensky asked why JE1 had told Committee counsel that Mr. Kamensky had threatened JE1 and asked if JE1 knew this could cause Mr. Kamensky to go to jail. JE1 responded that he had planned to bid, then Mr. Kamensky demanded Jefferies stand down to preserve their business relationship:

Hold on. Hold on a second, Dan. Listen to me. And then you call me and you say, do not bid. It's going to be a relationship issue, and so I said okay. Dan's a good relationship. What he's asking me to do makes me a little bit uncomfortable.

Mr. Kamensky reiterated that he could go to jail and urged JE1 to agree that Mr. Kamensky asking Jefferies to stand down was just a large misunderstanding.

Mr. Kamensky also urged JE1 to now take part in the bidding process for the Series B Shares. JE1 denied any further interest in having anything to do with the matter. Mr. Kamensky responded:

It's too late now. They're going to report this to the U.S. Attorney's Office, okay? They're reporting this to the U.S. Attorney's Office. This is -- this is -- it's, not like, not like you can't bid. The U.S. Attorney is going to investigate this. My position to them is this. I said to them, this a huge misunderstanding, okay, humongous misunderstanding and I told them -- the only thing I said was if you're not real don't bid and if they're real then they should bid. Because otherwise the U.S. Attorney is investigating this then, okay? They're going to report it, okay, and my position is - - is -- going to be look, this is was a huge misunderstanding. I never in a million years would have told them not to do that. I -- all I told them was if they're not real they shouldn't bid.⁹

JE1 later explained to the United States Trustee that Mr. Kamensky was trying to get JE1 to agree to his account of their phone conversation earlier that day. In fact, there had been no misunderstanding between them. Mr. Kamensky had made no inquiry whether Jefferies was

⁹ Quotations of the phone call are based on the transcript provided by JE1's counsel. The transcript matches the audio recording also provided by JE1's counsel.

“real,” i.e. a serious bidder, and had certainly not said it should bid if Jefferies was “real.” Mr. Kamensky had just demanded that Jefferies pull its bid.

In the call, JE1 again pushed back against the plausibility of Mr. Kamensky’s explanation, reminding him that Mr. Geller had been on the call as well and heard what Mr. Kamensky actually said. He urged Mr. Kamensky to just recuse himself from the whole matter. Mr. Kamensky again responded with a plea for JE1 to adopt his version of their earlier conversations, stressing the dire consequences for Mr. Kamensky if JE1 did not. Mr. Kamensky also admitted to abusing his position as a member of the Neiman Marcus Committee:

. . . [I]f you're going to continue to tell them what you just told me, I'm going to jail, okay? Because they're going to say that I abused my position as a fiduciary, which I probably did, right? Maybe I should go to jail. But I'm asking you not to put me in jail.

JE1 responded that there was no possibility of lying for Mr. Kamensky. Mr. Kamensky denied wanting JE1 to lie but kept urging JE1 to adopt his version of their earlier conversations.

JE1 again reiterated that Mr. Kamensky had pressured him to withdraw the bid to preserve their business relationship:

I thought you were very upset about it, okay, and I thought that you -- I thought that you were basically pushing me very hard to not put a bid and I thought about it and frankly it's not even worth it. It's not even important enough for me. So that's why because of my relationship with you I said okay. I don't want anything to do with this.

Mr. Kamensky then pleaded with JE1 to agree that Mr. Kamensky said something he purportedly intended to say but never actually did—that Jefferies should bid if it was serious. He implied that adopting this position was necessary to preserve their relationship:

I apologize. I apologize. I apologize, okay, and I'm telling you that what I intended to say, okay, is if you're not real don't bid but if you're real then you should bid, and, [JE1], for the relationship I would tell you that's exactly what I said and I apologize if I was upset or if it appeared as a threat.

He also repeated what he had set at the start of the call, “this conversation never happened,” referring to his efforts to influence JE1 but not have anyone know about these efforts.

But I'm telling you that is exactly what I intended to say and I'm just begging you to please appreciate that's what I meant to say and that this conversation never happened.

The United States Trustee questioned Mr. Kamensky concerning the above call recorded by JE1. Mr. Kamensky freely admitted he had made the call and said it was a serious mistake, one of the worst of his life. The United States Trustee played the audio recording of the call, and Mr. Kamensky verified it accurately captured his call with JE1. He stated he made the call out of fear and panic of the possible consequences of Jefferies’s report to the Committee that he had pressured them to withdraw from bidding. He denied wanting JE1 to lie but said he was trying to “manage the message” by talking with him. His hope was that he and JE1 could find “common ground” around Mr. Kamensky’s notion that the “calm” second half of their earlier call was meant to communicate that Jefferies should bid if it was serious, even though he never actually said that to JE1 and Mr. Geller during their first call that day. Mr. Kamensky admitted that his repeated statement that “this conversation never happened” was a recognition that attempting to influence JE1 might be considered improper. When questioned by the United States Trustee, Mr. Kamensky had no explanation for his use of the phrase “for the relationship” in his statement: “I'm telling you that what I intended to say, okay, is if you're not real don't bid but if you're real then you should bid, and, [JE1], for the relationship I would tell you that's exactly what I said.”

G. Marble Ridge Resigns from the Committee on August 1

At 8:31 AM ET on August 1, in advance of an emergency Committee meeting set for 2:00 PM ET, Mr. Weisfelner emailed Committee counsel on behalf of Mr. Kamensky and Marble Ridge. He again advanced the “misunderstanding” explanation of Mr. Kamensky’s conduct from

the day before, asserting that Mr. Kamensky had only contacted Jefferies to make sure it was truly committed to bidding, not to discourage a bid. Mr. Weisfelner, on Mr. Kamensky's behalf, asked the Committee professionals to assure Jefferies that it was strongly encouraged to submit a bid. Mr. Weisfelner mentioned Mr. Kamensky's continuing work on Marble Ridge's own cash out proposal. Finally, even though he believed Mr. Kamensky's conduct had been grossly misconstrued, Mr. Weisfelner stated that Marble Ridge would be resigning from the Committee as a way to resolve the issue in the best interests of all concerned.

At 1:15 PM ET, Mr. Weisfelner wrote to the United States Trustee to offer Marble Ridge's resignation from the Committee. In discussing the reasons for the resignation, Mr. Weisfelner provided the United States Trustee the substantially same "misunderstanding" explanation of Mr. Kamensky's July 31 conduct that he had provided to the Committee.

At the 2:00 PM ET emergency Committee meeting, given Marble Ridge's resignation, the Committee decided that counsel should promptly disclose Mr. Kamensky's conduct to the United States Trustee. Later that afternoon, Mr. Pachulski and Mr. Warner spoke by phone to Hector Duran, an attorney for the United States Trustee, and explained what they knew of the situation involving Mr. Kamensky and Marble Ridge. They advised Mr. Duran that they would provide him what they knew in writing and that the Committee would also disclose the situation to the Court.

H. Jefferies Renews Its Bid

Also on August 1, Jefferies decided to resume pursuit of its proposal to purchase Series B Shares. JE1 later explained to the United States Trustee that, given the turmoil following Jefferies's withdrawal, the business reasons behind the withdrawal no longer held. JE1 stressed that Jefferies's resumption of its proposal was not in response to Mr. Kamensky's request during

their phone call the prior evening that Jefferies bid in aid of his cover story. Instead, the renewed bid was motivated by Jefferies's own financial interest in a profitable transaction. During the morning of August 1, Mr. Geller and JE1 contacted Mr. Pachulski to inquire if the Committee would still be interested in a Jefferies cash out proposal for the Series B Shares. Mr. Pachulski said the Committee would be interested in a Jefferies proposal. He also asked Mr. Geller to reaffirm his explanation that Jefferies withdrew the day before in response to pressure from Mr. Kamensky. Mr. Geller did so. Mr. Pachulski asked if Mr. Kamensky had requested that Jefferies resume its bid. Mr. Geller responded that at the advice of counsel Jefferies could not provide any additional explanation beyond what it had already provided.

Committee counsel subsequently spoke with Mr. Sharp, Jefferies general counsel, who reported that Mr. Kamensky had phoned a Jefferies employee the evening of July 31, and "seemed concerned." This was apparently a reference to Mr. Kamensky's call with JE1 at approximately 8:08 PM ET. Mr. Sharp did not provide any other details. At the 2:00 PM ET Committee meeting that day, the Committee agreed to consider any renewed Jefferies cash out proposal.

I. The Court Orders the United States Trustee to Investigate Marble Ridge and Mr. Kamensky

On August 3, the Committee filed under seal an August 2 letter by Mr. Pachulski to United States Trustee attorney Hector Duran, laying out the facts about Mr. Kamensky and the Jefferies cash out proposal as the Committee understood them. Dkt. No. 1427. The Committee did not offer any conclusions as to Mr. Kamensky's conduct, but its narrative is consistent with the facts the United States Trustee has been able to establish during its subsequent investigation.

On August 4, Mr. Weisfelner, counsel to Marble Ridge Capital, filed under seal a declaration in his own name that provided an account of Mr. Kamensky's conduct ("Weisfelner

Declaration”). Dkt. No. 1432. Once again, Mr. Weisfelner advanced the “misunderstanding” explanation of Mr. Kamensky’s actions. As discussed below, the Weisfelner Declaration in several material respects is not consistent with the facts that the United States Trustee has established during the subsequent investigation.

In response to these filings, the Court on August 5, ordered both the Committee’s letter and the Weisfelner Declaration unsealed. The Court then required the United States Trustee “to file a statement of position within 14 days regarding the conduct of Marble Ridge and Mr. Kamensky in this case.” The United States Trustee began work immediately.

J. The Committee is Currently Considering Cash Out Proposals from Marble Ridge and Jefferies

In the meantime, both Jefferies and Marble Ridge submitted cash out proposals to the Committee. Jefferies submitted a Letter of Intent to the Committee on August 2. Marble Ridge provided a letter proposal on August 3, and then a revised proposal on August 11. Although the proposals are complex, each offers a higher price per share than the twenty cents of Marble Ridge’s original proposal. The United States Trustee understands that the Committee has not made a decision on any cash out proposal, and the Marble Ridge and Jefferies offers remain pending.

III. LEGAL ANALYSIS

When a creditor accepts appointment to an official creditors’ committee in a chapter 11 case, it agrees to assume certain fiduciary duties to other creditors. *See Westmoreland Human Opportunities, Inc. v. Walsh*, 246 F.3d 233, 256 (3rd Cir. 2001) (noting that section 1103 of the Bankruptcy Code “impl[ies] a fiduciary duty on the part of members of a creditor's Committee”). Those duties include a duty of loyalty, a duty of care, and a duty of disclosure. *See In re Farrell*, 610 B.R. 317, 323 (Bankr. C.D. Cal. 2019). A committee member owes its duties to the

represented creditors collectively, rather than to particular creditors individually. *In re Drexel Burnham Lambert Group, Inc.*, 138 B.R. 717, 722 (Bankr. S.D. N.Y. 1992).

Committee members differ from most other bankruptcy fiduciaries, however, in one important respect: committee members are not required to be disinterested, *see* 11 U.S.C. § 1102, and it is common for committee members to have individual economic interests that may be opposed to the debtor or to other creditors. *See In re Rickel & Assocs., Inc.*, 272 B.R. 74, 100 (Bankr. S.D.N.Y. 2002) (committee members are “hybrids who serve more than one master”). For this reason, a conflict of interest does not automatically prevent a creditor from serving on a committee—provided, however, that the creditor is otherwise able to exercise its fiduciary duties and provide adequate representation for the creditor body. *See In re First Republic Bank Corp.*, 95 B.R. 58, 61 (Bankr. N.D. Tex. 1988). In other words, committee members are not expected to abandon their personal interests, and are not prohibited from taking positions or actions that are adverse to other creditors or the estate outside the committee, so long as they do not take “unfair advantage” of their committee membership in order to do so. *In re El Paso Refinery, L.P.*, 196 B.R. 58, 75 (Bankr. W.D. Tex. 1996).

The United States Trustee has the statutory duty to monitor creditors’ committees, is responsible for soliciting and appointing members to committees, and may reconstitute or remove members from committees if necessary. 28 U.S.C. § 586(a)(3)(E), 11 U.S.C. § 1102(a). In the United States Trustee’s experience, the solicitation and appointment process itself can often forestall or mitigate many threats to the integrity of committees. Potential committee members are advised of their fiduciary duties in advance of their appointment, and potential members will be questioned extensively about any positions, interests, or status that may affect their behavior as fiduciaries before being appointed. Potential committee members are also advised of their

obligation to notify the United States Trustee of any changed circumstances that arise during the case that may affect their ability to serve. If there is doubt about a creditor's willingness or ability to act as a fiduciary, that creditor will typically not be appointed, and a creditor who violates these duties or becomes unable to perform those duties after appointment may be removed. *See In re America West Airlines*, 142 B.R. 901, 902 (Bankr. D. Ariz. 1992) (upholding United States Trustee's removal of creditor from committee).

IV. CONCLUSIONS

Although some details and interpretations remain in dispute, the substantial evidence collected to date clearly demonstrates that Mr. Kamensky breached his fiduciary duty to unsecured creditors on July 31, and his earlier conduct between July 4 and July 30 was problematic. After being told both of the existence of a rival bid and the identity of the bidder, Mr. Kamensky sought to exploit that information for his own benefit by contacting Jefferies and pressuring them to withdraw their initial bid, to the likely detriment of all other creditors.¹⁰ In the course of those conversations with JE1, Mr. Kamensky improperly suggested to JE1 that he could prevent a successful Jefferies bid because of his role as Committee co-chair. Regardless of whether Mr. Kamensky actually had the power to ensure that the Committee rejected any Jefferies bid, this type of coercion by a Committee fiduciary is highly inappropriate. Moreover, Marble Ridge's initial representations regarding the conversations between Mr. Kamensky and Jefferies, which

¹⁰ Marble Ridge's actions might have been prevented had the Court and the United States Trustee been notified that Marble Ridge intended to engage in a self-interested transaction as early as July 4. Wider awareness of Marble Ridge's intentions might have called into question its ability to continue serving on the Committee or at least led to more stringent procedures to avoid a breach of fiduciary duty.

minimized Mr. Kamensky's role in Jefferies's withdrawal of its initial offer and which suggested that Mr. Kamensky was surprised by that result, are inconsistent with the evidence regarding those same conversations, including Mr. Kamensky's own later testimony. His actions were a clear abuse of his Committee position and a breach of his duty.

As a number of courts have held—and, indeed, as Mr. Kamensky himself appears to have admitted in his conversation with JE1—his actions of July 31 are paradigmatic examples of a breach of a committee member's duties. *See Rickel*, 272 B.R. at 100 (committee member breaches its duty by using its position to monopolize negotiations, effectively freezing out other bidders, or by exploiting confidential information known only to it through its committee service in order to seize an advantage); *In re Refco Inc.*, 336 B.R. 187, 198 n.13 (Bankr. S.D.N.Y. 2006) (“a Committee member's fiduciary duties do not preclude it from representing its own interests, provided that in so doing it does not abuse its position on the Committee at the expense of the creditor class”). *See also In re Russo*, 762 F.2d 239, 243 (2d Cir. 1985) (directing bankruptcy court to consider whether asset sale was tainted due to former fiduciary's misuse of confidential information).

As this Court observed in its August 5 Order, effective committees are critical to a robust chapter 11 process, and any threats to their integrity and function must be resolved promptly and publicly:

A creditors' committee in a large commercial case serves an especially important role in the bankruptcy process. A properly functioning committee adds transparency and public confidence to a complicated and often confusing process. The Court relies on a committee's views to add depth and balance to the myriad of commercial issues that it considers. Any threat that endangers this delicate balance must be resolved promptly and in a public manner.

Order, Dkt. No. 1442.

Although the issues discussed and conclusions drawn in this statement are supported by substantial evidence, this investigation was preliminary, and no party has had an opportunity to respond to or rebut the United States Trustee's statement. In the Court's order of August 5, the Court cited possible remedial actions, including the creditors' remedy of subordination of claims under 11 U.S.C. § 510(c).¹¹ To the extent the Court believes that further relief may be appropriate under these or any other provisions, such relief should be considered in a formal proceeding in open court so that the Court may hear and consider all relevant evidence.

Dated: August 19, 2020

Respectfully Submitted,

HENRY G. HOBBS, JR.
ACTING UNITED STATES TRUSTEE
REGION 7, SOUTHERN and WESTERN
DISTRICTS OF TEXAS

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served by electronic means on all PACER participants on this 19th day of August 2020.

/s/ Hector Duran
Hector Duran, Trial Attorney

¹¹ The Court also cited 18 U.S.C. § 152(6), and consistent with long-standing practice, the United States Trustee does not opine publicly about possible implications of title 18 in this statement.

The Ethics of Virtual Representation: An Outline of Selected Discussion Topics

By: Cynthia A. Norton
U.S. Bankruptcy Court W.D. Missouri
Midwestern Bankruptcy Institute
Oct. 2021

ABA Formal Opinion 498: “Lawyers can practice law virtually but must ensure that they consider various ethical responsibilities related to the duties of competence, diligence, communication, confidentiality and supervision.” <https://www.abajournal.com/news/article/ethics-opinion-addresses-professional-responsibilities-of-virtual-practice> (March 10, 2021)

I. Rule 1.1 Competence Issues

- Has the necessity of doing remote hearings/depositions/mediations changed the standard of care, with respect to the duty to keep abreast of changes in the law and practice, including the benefits and risks associate with relevant technology under Rule 1.1?
- Are judges expecting more of attorneys with respect to technological competence?
- Does the duty of competency include soft presentation skills, like awareness of lighting, background, camera angles, for you and your witness?

II. Rule 1.2 Consent Issues

- Is obtaining your client’s informed consent more difficult in a virtual setting?
- Have you developed any best practices for obtaining a client’s written “informed consent” in a virtual setting?

III. Rule 1.3 Diligence

- Has virtual practice changed how you keep on top of upcoming hearings and deadlines?
- Have you had to change any of your calendaring systems?

IV. Rule 1.4 Communication

- How has virtual practice changed the way you communicate with clients?
- Has the informality of emails and texts presented any issues in your practice?
- Do you believe that a virtual consultation (particularly with a debtor client) can be effective? Why or why not?
- What about those difficult or sticky conversations every lawyer must have from time-to-time – can you effectively communicate bad news virtually?

V. Rule 1.6 Confidentiality

- Do you worry about the security of your clients' confidential information when working from a remote location?
- Have you taken additional steps to beef up the security settings on your phones, home internet, devices, computers?
- Has working at home presented problems keeping files and conversations confidentially, particularly when children or other family members may also be schooling or working at home?

VI. Rule 3.4 Fairness to Opposing Party & Counsel (Coaching)

- Do you believe other lawyers are improperly coaching their witnesses during depositions or trial?
- What steps do you take to make sure the opposing party is not surreptitiously providing answers or unauthorized exhibits to the remote witness you are examining?
- Have you changed the way in which you examine the opposing party's witnesses?

VII. Coronavirus Safety (invoking Rule 1.7 Conflicts of Interest, Rule 3.3 Candor to the Tribunal, plus Competence, Consent and Communication)

- Have you experienced a situation which you felt your need to stay safe conflicted with a client's desire to have a live trial? Or vice-versa?
- Have you experienced a situation in which a judge imposed safety constraints on a mediation, deposition, hearing or trial that you thought were not in your client's best interests?
- Are some parties using the pandemic as a litigation tactic or strategy to delay?

VIII. Rules 5.1, 5.2, and 5.3 Supervision

- Have you had concerns about your duty to supervise subordinate lawyers or nonlawyer assistants in a remote environment?

IX. Rule 5.5 Unauthorized Practice of Law

- Do you live in a state in which you are not licensed?
- Have you had to consider whether working remotely from another state may constitute the unauthorized practice of law in that state?

X. Decorum (invoking Rule 3.5(d) & Rule 8.2 – Undignified or Discourteous Conduct Degrading to the Tribunal)

- Do you worry about you or your client having a “hot mic” moment in which something disparaging is said about the judge?
- Does the nature of phone and virtual hearings make it more likely that third parties might engage in behaviors that disrupt the proceedings?

XI. Rule 8.4(d) Conduct Unbecoming

- Have you witnessed more or fewer lawyer bad behavior during virtual representation?
- Do you worry that a client or opposing counsel/party might secretly record a hearing or mediation and post it for the purpose of gaining a litigation advantage?
- Have you experienced lawyers behaving inappropriately from a remote location (e.g., inappropriate clothing, no clothing, in the bathroom, in a bed, drinking alcohol, etc.)
- If you witnessed such behavior during a deposition, do you think you would have a duty to report under Rule 8.3?

XII. General Discussion on Lawyer Wellness & Ethics of Virtual Representation & Remote Work

- Has working remotely improved the quality of your life as a professional? Why or why not?
- Are there particular stresses from virtual practice that impact lawyer wellness?
- Do you want to return to live hearings/depositions/mediations?

BIFURCATED FEES IN CHAPTER 7

Judge Anita L. Shodeen
Southern District of Iowa

Lamie v. U.S. Trustee concluded that attorney fees could not be paid from bankruptcy estate funds. 540 U.S. 526 (2004). This holding in conjunction with other circuit court decisions resulted in attorney's fees remaining unpaid and subject to discharge. New concepts on the structure and payment of fees in the context of chapter 7 cases have since been implemented by some debtor attorneys. Recently, courts have addressed whether the use of bifurcated fee arrangements in bankruptcy, for no or low money down, are appropriate. The UST has brought these arrangements to the courts' attention in a variety of ways, including motions for sanctions, examination of fees, and the unreasonableness of the fees. No consensus has emerged on this issue. Most cases are fact specific and primarily focus on whether the attorney has complied with applicable bankruptcy code provisions, ethical rules and/or local rules to determine whether the bifurcated fee can be enforced. What follows is a summary that highlights the issues and applicable legal authority.

1. Issues

- a. Options for Fee Payments
- b. How Fee Payments are challenged
- c. Ethical Considerations and Competency
- d. Fee Agreement or Finance Arrangement
- d. Access to Justice

2. Case Law

➤ Approval of bifurcated fee arrangement:

In re Brown, -- B.R. --, Case no. 20-23632-BKC-LMI, 2021 WL 2460973 (Bankr. S.D. Fla. June 6, 2021) (detailed discussion of bifurcated fee agreements that meet applicable legal standard to be enforced).

In Re Carr, 613 B.R. 427 (Bankr. E.D. Ky. 2020) (bifurcated fee agreements are enforceable if done properly)

In re Hazlett, Case No. 16-30360, 2019 WL 1567751 (Bankr. D. Utah April 10, 2019) (Summary judgement entered in favor of counsel in no money down post-petition financing agreement).

In re Slabbinck, 482 B.R. 576 (Bankr. E.D. Mich. 2012) (executing a separate fee agreement after case filing prevented discharge of attorney fees incurred for post-petition representation).

➤ Denial of bifurcated fee arrangement

Allen v. Casamata (In Re Allen), 628 B.R. 641 (8th Cir. BAP 2021) (increased fee for post-petition payment of attorney fees were not reasonable based upon the services provided)

In re Prohpet, 628 B.R. 788 (Bankr. D. S.C. 2021) (bifurcated fee arrangement not enforceable resulting in disgorgement of fees).

In re Driggers, Case No. 20-03239-dd, 2021 WL 2134647 (Bank. D. S.C. May 25, 2021) (retention agreements declared void for inadequate disclosure, unreasonable/excessive fees and unauthorized practice of law)

In re Wright, 591 B.R. 68 (Bankr. N.D. Okla. 2018) (voided post-petition fee agreements disgorgement of fees paid thereunder in 17 cases for violation of disclosure requirements and fraud by counsel; factoring agreements questioned but not directly addressed).

In re Michel, 509 B.R. 99 (Bankr. E.D. Mich. 2014) (oral agreement to pay a portion of fees post-petition not enforceable)

3. Relevant Statutes

- 11 USC §329 Debtor's Transactions with Attorneys
 - (a) disclosure
 - (b) reasonablenessForm B2030 DISCLOSURE OF COMPENATION OF ATTORNEY FOR DEBTOR
- 11 USC §521 Debtor's Duties
- 11 USC §526 Restrictions on Debt Relief Agencies
- 11 USC §528 Requirements for Debt Relief Agencies
- 11 USC §524 Effect of Discharge
- 11 USC §727(b) Discharge

STUDENT LOAN LITIGATION IN BANKRUPTCY



Hon. Kathy A. Surratt-States

United States Bankruptcy Court for the Eastern District of Missouri

Student Loan Litigation in Bankruptcy

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Student Loan Litigation in Bankruptcy¹

A. Tests for undue hardship to discharge student loans under §523(a)(8)

a. *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987)

Brunner Test. *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987). To discharge student loans a debtor must establish by a preponderance of the evidence that: (1) the debtor cannot maintain a minimal standard of living; (2) additional circumstances exist to show that the debtor's financial condition is likely to persist for a significant portion of the repayment period; and (3) the debtor made a good faith attempt to repay the loan.

Case Summary

Facts: Marie Brunner, pro se debtor, appealed from a decision of the United States District Court for the Southern District of New York, which held that it was an error for the Bankruptcy Court to discharge her student loans based on “undue hardship,” 46 B.R. 752 (S.D.N.Y.1985). The District Court determined that Brunner did not establish her eligibility for a discharge of her student loans based on undue hardship. The record demonstrates no “additional circumstances” indicating a likelihood that her current inability to find any work will extend for a significant portion of the loan repayment period. Brunner is not disabled, nor elderly, and she has—so far as the record discloses—no dependents. No evidence was presented indicating a total foreclosure of job prospects in her area of training. At the time of the hearing, only ten months had elapsed since Brunner's graduation from her master's degree program. Finally, as noted by the District Court, Brunner filed for the discharge within a month of the date the first payment of her loans came due. Moreover, she did so without first requesting a deferment of payment, a less drastic remedy available to those unable to pay because of prolonged unemployment. Such conduct does not evidence a good faith attempt to repay her student loans.²

Holding: The Second Circuit Court of Appeals affirmed, holding that:

- (1) for a debt to be dischargeable on basis of “undue hardship,” debtor must show an inability to maintain a “minimal” standard of living for self and dependents if forced to repay loans, that additional circumstances exist indicating that state of affairs is likely to persist for a significant portion of the repayment period of student loans, and that debtor has made good-faith efforts to repay loans,³ and
- (2) Chapter 7 debtor failed to establish that her current inability to find work would extend for a significant portion of the student loan repayment period or that she had made a good-faith attempt to repay student loans, and thus failed to establish “undue hardship” as required for a discharge of loans.⁴

¹ The *Brunner* test is generally followed by the Second, Third, Fourth, Fifth, Sixth, Seventh, Ninth, and Eleventh Circuits.

² *Brunner*, 831 F.2d at 396-97.

³ *Brunner*, 831 F.2d at 396.

⁴ *Id.*

b. Long v. Educ. Credit Mgmt. Corp., 322 F.3d 549 (8th Cir. 2003)

Totality of Circumstances Test. The Eighth Circuit developed a totality of the circumstances test in *Long v. Educ. Credit Mgmt. Corp.*, 322 F.3d 549, 554 (8th Cir. 2003), where the court must consider (1) debtor's future financial condition, (2) debtor's and dependent's reasonable and necessary living expenses, and (3) other relevant facts and circumstances surrounding each particular bankruptcy case.

Case Summary

Facts: Educational Credit Management Corporation (hereinafter "ECMC") appealed the Bankruptcy Appellate Panel's (hereinafter "BAP") decision affirming the Bankruptcy Court's discharge of Nanci Long's student loan debt. This case required the Eighth Circuit Court of Appeals to address the undue hardship provision found in 11 U.S.C. § 523(a)(8)(B). ECMC argues that the Bankruptcy Court erred in its determination that repayment of the debt would impose an undue hardship on appellee. ECMC also contends that the BAP relied on an incorrect review standard to reach its decision.⁵ The Eighth Circuit Court of Appeals reversed and remanded to the BAP.

Nanci Long (hereinafter "Appellee"), was a thirty-nine-year old, single-mother. In 1987, she passed her state-board examination. Until 1990, she worked as a chiropractor in various clinics. Appellee owned and operated a successful chiropractic practice from 1990 until 1993. At some point in 1993, Appellee began to experience extreme fatigue, depression, and diminution of her mental faculties. These symptoms increasingly affected her work, causing a substantial drop in her clientele. In 1995, Appellee terminated her chiropractic practice altogether, citing an inability to handle life changes. She continued in a downward economic and emotional spiral. At one point, she attempted suicide. At the time of the trial, she was gainfully employed and was pursuing an additional college degree. According to Appellee, her symptoms included severe, short-term memory loss, persistent ache, dramatic weight gain, and anxiety about being in public places. In order to treat her condition, appellee takes various prescription drugs and sleeps in excess of twelve hours per day.⁶

The Bankruptcy Court found that Appellee's medical condition will persist into the future and will interfere with her future earning potential. The Bankruptcy Court concluded that the severity and historical intensity of Appellee's illness and overall prognosis would prevent Appellee from earning enough money to "dig herself out of these...loans."⁷ After conducting a review for clear error, a divided BAP summarily affirmed the Bankruptcy Court's decision. On appeal, ECMC argues that the BAP should have used the de novo standard in its review of the Bankruptcy Court's undue hardship determination. ECMC also contends that Appellee's student loans were not dischargeable under § 523(a)(8)(B), because the loans did not impose an undue hardship.⁸

⁵ *In re Long*, 322 F.3d at 551.

⁶ *Id.*

⁷ *In re Long*, 322 F.3d at 551-552.

⁸ *Id.*

Holding: The Eighth Circuit Court of Appeals held that:

A less restrictive approach to the “undue hardship” inquiry is preferred.⁹ The Eighth Circuit Court of Appeals is convinced that requiring bankruptcy courts in the Eighth Circuit to adhere to the strict parameters of a particular test would diminish the inherent discretion contained in § 523(a)(8)(B). “Therefore, we continue—as we first did in *Andrews*—to embrace a totality-of-the-circumstances approach to the ‘undue hardship’ inquiry.”¹⁰ “We believe that fairness and equity require each undue hardship case to be examined on the unique facts and circumstances that surround the particular bankruptcy.”¹¹

In evaluating the totality-of-the-circumstances, reviewing Bankruptcy Courts in the Eighth Circuit should consider: (1) debtor's past, present, and reasonably reliable future financial resources; (2) a calculation of debtor's and her dependent's reasonable necessary living expenses; and (3) any other relevant facts and circumstances surrounding each particular bankruptcy case.¹²

Simply put, if debtor's reasonable future financial resources will sufficiently cover payment of the student loan debt while still allowing for a minimal standard of living-then the debt should not be discharged. Certainly, this determination will require a special consideration of debtor's present employment and financial situation-including assets, expenses, and earnings along with the prospect of future changes positive or adverse in the debtor's financial position.¹³

c. *In re Gerhardt*, 348 F.3d 89 (5th Cir. 2003)

Brunner plus “Total Incapacity” to Repay Test. The Fifth Circuit added to the *Brunner* test by holding that discharging student loans requires the debtor to specifically prove “a total incapacity ... in the future to pay [his] debts for reasons not within [his] control.” *In re Gerhardt*, 348 F.3d 89, 92 (5th Cir. 2003) citing *In re Faish*, 72 F.3d 298, 307 (3d Cir.1995). In other words, the debtor must show that circumstances out of her control have resulted in a ‘total incapacity’ to repay the debt now and in the future.

Case Summary

Facts: Chapter 7 debtor sought discharge of his student loans. The Bankruptcy Court for the Eastern District of Louisiana entered judgment in favor of debtor, and creditor appealed. The District Court reversed.

Over a period of years, Jonathon Gerhardt obtained over \$77,000 in government-insured student loans to finance his education at the University of Southern California, the Eastman School of Music, the University of Rochester, and the New England Conservatory of Music. Gerhardt is a professional cellist. He subsequently defaulted on each loan owed to the United States Government. In 1999, Gerhardt filed for Chapter 7 bankruptcy and thereafter filed an adversary proceeding seeking discharge of his student loans pursuant to 11 U.S.C. § 523(a)(8). The Bankruptcy Court discharged Gerhardt's student loans as causing undue hardship. On appeal, the District Court reversed, holding that it would not be an undue hardship for Gerhardt

⁹ *Andrews v. South Dakota Student Loan Assistance Corp. (In re Andrews)*, 661 F.2d 702, 704 (8th Cir.1981).

¹⁰ *In re Long*, 322 F.3d at 554.

¹¹ *Id.*

¹² *Andresen v. Nebraska Student Loan Program, Inc. (In re Andresen)*, 232 B.R. 127 (8th Cir. B.A.P. 1999).

¹³ *In re Long*, 322 F.3d at 554-555.

to repay his student loans.¹⁴ Finding no error, the Fifth Circuit Court of Appeals affirmed the District Court's judgment.

Holding: The Fifth Circuit Court of Appeals affirmed, holding that:

To justify discharging debtor's student loans, the *Brunner* test requires a three-part showing:

- (1) that debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for [himself] and [his] dependents if forced to repay the loans;
- (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
- (3) that debtor has made good faith efforts to repay the loans.¹⁵

Because the Second Circuit presented a workable approach to evaluating the undue hardship determination, the Fifth Circuit Court of Appeals *expressly* adopted the *Brunner* test for purposes of evaluating a Section 523(a)(8) decision.¹⁶

"The second prong of the *Brunner* test asks if 'additional circumstances exist indicating that this state of affairs is likely to persist [for a significant period of time].'"¹⁷ "Additional circumstances' encompass 'circumstances that impacted on the debtor's future earning potential but which [were] either not present when the debtor applied for the loans or [have] since been exacerbated.'"¹⁸

Thus, the Fifth Circuit ultimately held that "proving that the debtor is 'currently in financial straits' is not enough."¹⁹ "Instead, the debtor must specifically prove "a total incapacity ... in the future to pay [his] debts for reasons not within [his] control."²⁰

d. *In re Matter of Thomas*, 931 F.3d 449 (5th Cir. 2019)

Brunner plus "Intolerable Difficulties" Test. The Fifth Circuit also tightened the *Brunner* test by ruling that a debtor may not discharge a student loan unless repayment would impose intolerable difficulties on the debtor. *In re Matter of Thomas*, 931 F.3d 449 (5th Cir. 2019).

Case Summary

Facts: Chapter 7 debtor brought adversary proceeding against the Department of Education seeking determination that she was entitled to undue hardship discharge of \$7,806.45 student loan debt. The United States Bankruptcy Court for the Northern District of Texas denied

¹⁴ *In re Gerhardt*, 348 F.3d at 90-91.

¹⁵ *In re Gerhardt*, 348 F.3d at 91 (quoting *Brunner*, 831 F.2d at 396).

¹⁶ *Id.*

¹⁷ *In re Gerhardt*, 348 F.3d at 92 (quoting *Brunner*, 831 F.2d at 396).

¹⁸ *In re Gerhardt*, 348 F.3d at 92 (quoting *In re Roach*, 288 B.R. 437, 445 (Bankr.E.D. La. 2003)).

¹⁹ *In re Gerhardt*, 348 F.3d at 92 (quoting *In re Brightful*, 267 F.3d 324, 327 (3d Cir.2001)).

²⁰ *In re Gerhardt*, 348 F.3d at 92 (quoting *In re Faish*, 72 F.3d 298, 307 (3d Cir.1995) (quoting *In re Rappaport*, 16 B.R. 615, 617 (Bankr.D.N.J.1981)).

discharge of student loan debt. Debtor appealed and the District Court affirmed. Debtor appealed again.²¹

Vera Frances Thomas, the Appellant, is over 60 years old and had to file a Chapter 7 bankruptcy case in 2017. Ms. Thomas suffers from diabetic neuropathy, a degenerative condition that causes pain in her lower extremities. Ms. Thomas is now unemployed and subsists on a combination of public assistance and private charity. In February 2012, however, she had worked for eight years at a call center in Southeastern Virginia and was earning \$11.40 per hour with benefits. That year, Ms. Thomas decided to enroll at a local community college to improve her career prospects (she had a high school diploma, but no higher education credits). She obtained two \$3,500 loans through the Department of Education, the first on February 14, 2012 and the second on September 21, 2012 to finance her first two semesters of courses. Ms. Thomas did not return for a third semester, and her loans went into repayment in December 2013. In spring 2014, she made payments of \$41.24 and \$41.61 on the loans.²²

Ms. Thomas' health began to decline significantly in 2014 when she was diagnosed with diabetic neuropathy. The condition, which often reduces circulation in patients' lower extremities, caused muscle weakness, numbness, and pain in her legs and feet after prolonged standing. Ms. Thomas frequently took unpaid leave from work at the call center to manage her symptoms and incurred significant medical expenses. In 2016, her employer was acquired by another company, and the new employer fired her for violating company policies. Because she was terminated for cause, Ms. Thomas was ineligible for unemployment benefits.²³

To defray costs, Ms. Thomas moved to Texas to live with her then-boyfriend. She obtained work with Perfumania, then Whataburger, and finally UPS. But each job required her to be on her feet, and she could not maintain these positions. Since quitting UPS in 2017, Ms. Thomas has not obtained employment that comports with her need for sedentary work. Unable to make payments on her student loans and other significant debts, Ms. Thomas filed Chapter 7 bankruptcy in Dallas and received a general discharge of her debts. Seeking a discharge of her student loan debt as well, Ms. Thomas initiated an adversary complaint in Bankruptcy Court against the Department of Education.²⁴

Holding: The Fifth Circuit Court of Appeals affirmed, holding that:

Debtor's inability to pay her student loans and maintain a minimal standard of living was not likely to persist throughout a significant portion of the loans' repayment period. The plain meaning of the words chosen by Congress is that student loans are not to be discharged unless requiring repayment would impose intolerable difficulties on the debtor.²⁵ The threshold by definition must be greater than the ordinary circumstances that might force one to seek bankruptcy relief.²⁶

²¹ *In re Matter of Thomas*, 931 F.3d 449.

²² *In re Matter of Thomas*, 931 F.3d 450.

²³ *Id.*

²⁴ *Id.*

²⁵ *In re Matter of Thomas*, 931 F.3d at 454.

²⁶ *Id.*

e. *Educ. Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302 (10th Cir. 2004)

Brunner plus “Acting in Good Faith” Test. Tenth Circuit adopted its version of the *Brunner* test in *Educ. Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302 (10th Cir. 2004).

Case Summary

Facts: Plaintiff/Appellee Nancy Jane Polleys sought a bankruptcy court discharge of federally guaranteed student loans. Defendant/Appellant Education Credit Management Corporation (hereinafter “ECMC”) is a non-profit company and fiduciary of the Department of Education that is charged with collecting such loans. It now holds these loans. Ms. Polleys initiated an adversary proceeding in bankruptcy, contending that the loans were dischargeable because payment of them would impose an undue hardship within the meaning of 11 U.S.C. § 523(a)(8). The Bankruptcy Court agreed and discharged the loans. The District Court affirmed. ECMC appealed.²⁷

At the time of trial, Ms. Polleys was a 45-year old single mother of a teenaged girl. In 1993, she obtained a degree in accounting financed with student loan funds. She has not repaid any amount on these loans. Her loans were later consolidated, and at the time of trial had a balance of approximately \$51,000; repayment would require \$420 per month over a period of 20 years. Ms. Polleys was previously employed as an accountant. In 1994, she worked for one year in that capacity and earned \$33,000. She had a job in public accounting in 1997, earning \$13,771. According to Ms. Polleys, she was laid off from that job when the employer realized she was taking antidepressant medication and she asked for too much help. Ms. Polleys also tried self-employment but could only get small bookkeeping jobs that paid less than \$400 per month. Since 1997, Ms. Polleys's annual income has been as high as \$16,000 and as low as \$3,000.

Ms. Polleys and her daughter live in a rental property owned by her parents and pay no rent or utilities. She has a 1993 Subaru, which has significant body damage, but owns very little other property and no real property. Her budget contains no funds for emergencies. She qualifies for food stamps, and her income is below the federal poverty guidelines, as it was in the year before trial. Although her daughter is eligible for Medicaid, Ms. Polleys herself has no health insurance. Ms. Polleys is apparently in good physical health, but she has been diagnosed with and continues to suffer from a psychological condition known as ‘cyclothymic disorder’.²⁸

Holding: The Tenth Circuit Court of Appeals affirmed, holding that:

- (1) showing of a certainty of hopelessness was not required to demonstrate inability to maintain minimum standard of living if forced to repay loans;
- (2) whether debtor has made good faith efforts to repay loans should depend on the legitimacy of the basis for seeking a discharge;
- (3) debtor had inability to maintain minimum standard of living if forced to repay student loans which was likely to persist for significant portion of loan repayment period;
- (4) debtor sought discharge in good faith; and

²⁷ *Educ. Credit Mgmt. Corp. v. Polleys*, 356 F.3d at 1304.

²⁸ *Id.* at 1305.

(5) debtor demonstrated undue hardship, entitling her to discharge.²⁹

B. Recent Cases

a. *Tingling v. Educ. Credit Mgmt. Corp. et al.*, 990 F.3d 304 (2d Cir. 2021)

Recent reaffirmance of *Brunner* by the Second Circuit. *Tingling v. Educ. Credit Mgmt. Corp. et al.*, 990 F.3d 304 (2d Cir. 2021).

Case Summary

Facts: Chapter 7 debtor filed an adversary complaint seeking [a] determination that her educational loans were dischargeable and subsequently moved to seal the case and for a default judgment against the United States Department of Education (hereinafter “DOE”). After loan guarantor’s motion to intervene was granted and debtor’s default motion was denied, trial was held. The Bankruptcy Court for the Eastern District of New York determined that debtor failed to satisfy the *Brunner* test and, accordingly, that her student loans were not dischargeable. Debtor, proceeding pro se, appealed. The District Court affirmed. Debtor appealed.³⁰

In August 2016, [D]ebtor/Appellant Janet Tingling (hereinafter “Tingling”) sought relief from her student debt by filing a complaint against student loan holder United States Department of Education and others. On consent of the parties, the Bankruptcy Court granted the motion of Educational Credit Management Corporation to intervene as the assignee of eight of the loans. On April 15, 2019, the Bankruptcy Court entered a final judgment, holding that Tingling’s student loans were non-dischargeable and that Tingling had failed to prove undue hardship. Tingling appealed to the District Court, which affirmed the Bankruptcy Court’s judgment...The District Court further held that the Bankruptcy Court did not abuse its discretion when it adopted the July 31, 2018 joint pretrial memorandum as the basis for its Pretrial Order and declined to incorporate Tingling’s later unilateral revisions.³¹

Holding: The Second Circuit Court of Appeals affirmed, holding that:

- (1) The Bankruptcy Court did not abuse its discretion in basing its Pretrial Order on the joint pretrial memorandum dated July 31, 2018.³² Nor was it an abuse of discretion for the Bankruptcy Court to not permit Tingling to unilaterally modify that joint pretrial memorandum, as the interests of justice in this case did not so require.³³
- (2) Tingling failed to make the factual showing to establish “undue hardship” under *Brunner*, as would be required to discharge her educational loans.³⁴

²⁹ *Id.* at 1302.

³⁰ *In re Tingling*, 990 F.3d at 304.

³¹ *Id.* at 306-307.

³² *Id.* at 304.

³³ *Id.*

³⁴ *Id.*

b. *Educ. Credit Mgmt. Corp. v. Goodvin*, 2021 WL 1026801 (D. Kan. 2021)

Compare *Tingling* to *Educ. Credit Mgmt. Corp. v. Goodvin*, 2021 WL 1026801 (D. Kan. 2021) that found that debtor could satisfy the *Brunner* test because debtor could not pay accruing interest on the student loan and still maintain a minimal standard of living.

Case Summary

Facts: After he filed for Chapter 7 bankruptcy, Debtor Jeffrey Goodvin initiated in the Bankruptcy Court an adversarial proceeding against the United States Department of Education (hereinafter “DOE”) and defendant Educational Credit Management Corporation (hereinafter “ECMC”), by which Mr. Goodvin sought discharge of certain student loans held by DOE and ECMC pursuant to 11 U.S.C. § 523(a)(8).³⁵ At the time of trial, Mr. Goodvin was 57, single, and had no dependents. In total, Mr. Goodvin owed \$77,000 on his student loans, which are accruing interest at a rate of \$503 per month.³⁶ On July 15, 2020, the Bankruptcy Court conducted a trial at which the parties offered documentary evidence and stipulations of fact and at which Mr. Goodvin testified. On September 1, 2020, the Bankruptcy Court issued a written opinion in which it made various findings of fact; concluded that Mr. Goodvin had shown the necessary ‘undue hardship’; and partially discharged the student loan debt, specifically discharging Mr. Goodvin’s debt on a 1992 consolidation loan held by ECMC, but excepting from discharge the debt on ECMC’s other loan and on DOE’s loans.³⁷

ECMC appealed that decision to the United States District Court for the District of Kansas. ECMC challenged particular findings of fact relating to Mr. Goodvin’s expenses, and it argued that the Bankruptcy Court erred in concluding that Mr. Goodvin satisfied the undue hardship standard. ECMC also argued that, if that standard is deemed satisfied, the Bankruptcy Court abused its discretion in discharging only the debt on one loan instead of spreading the partial discharge among all debts on a pro rata basis. The Court rejected ECMC’s arguments, and it therefore affirmed the Bankruptcy Court’s partial discharge.³⁸

Holding: The United States District Court for the District of Kansas held that:

- (1) disposable income insufficient even to pay accruing interest can prove “undue hardship” under 11 U.S.C. § 523(a)(8); and
- (2) the availability of an income-based repayment program will not automatically preclude the discharge of student loans.³⁹

c. *Parvizi v. United States Dep’t of Educ., et al., (In re Parvizi)*, 2021 Bankr. LEXIS 1283 (Bankr. D. Mass. May 12, 2021)

Bankruptcy Court in Massachusetts discharged part of debtor’s student loans under Section 105(a) after finding that in Massachusetts the bankruptcy courts use the totality of the circumstances test. *Parvizi v. United States Dep’t of Educ., et al.*

³⁵ *Educ. Credit Mgmt. Corp. v. Goodvin*, 2021 WL 1026801, at *1.

³⁶ *Id.* at *2.

³⁷ *Id.* at *1.

³⁸ *Id.*

³⁹ See Bill Rochelle, *Inability to Cover Accruing Interest Was Pivotal on Discharging Student Loans*, AMERICAN BANKRUPTCY INSTITUTE (Mar. 22, 2020).

Case Summary

Facts: As of the trial date, Debtor was 51 years old, had no physical or mental conditions that impede her ability to work, and did not have any dependents. From 1997 through 2012, Debtor received various student loans to fund her extensive education. As a result of that education, Debtor has obtained multiple degrees and is fluent in at least four languages. In 1990, Debtor obtained a bachelor's degree in philosophy and biochemistry from Clark University. Thereafter, she attended medical school but voluntarily left before receiving a degree. In 2007, Debtor received \$100,000 from her father and offered to compromise her extant \$123,000 student loan balance for \$45,000. The United States Department of Education (hereinafter "DOE") rejected the offer because, based on Debtor's financial statement, the DOE believed that Debtor had an ability to pay the loan...In 2008, Debtor returned to medical school at St. George's University School of Medicine (financed by additional student loans) and graduated with a Doctor of Medicine in 2012. In June 2012, Debtor began a four-year residency program in psychiatry at the University of Vermont, earning \$50,000 per year. But Debtor did not complete the residency program and left in January 2013. Debtor testified that, as a result of a conflict with her supervisor, Debtor was put on a remediation plan and was then placed on leave pending an appeal. Debtor admitted that she decided not to pursue the appeal and, instead, chose to resign. Despite her many attempts, Debtor was never offered an interview for, nor admitted to, another residency program. Since 2014, Debtor has primarily obtained employment in the education field. For tax years 2016 through 2019, Debtor's annual income was \$21,588, \$20,876, \$41,336, and \$28,668, respectively. Debtor estimated that she earned \$2,500 per month in early 2020.⁴⁰

The DOE holds two types of Debtor's student loans - federal government funded loans through the William D. Ford Federal Direct Loan Program (hereinafter the "Direct Loans") and privately funded student loans that are guaranteed and held by the federal government through the Federal Family Education Loan Program (hereinafter the "FFELP Loans"). As of September 10, 2020, the outstanding total balance of the Direct and FFELP Loans totaled \$653,843.22, comprised of \$478,070.53 in unpaid principal and \$175,772.80 in interest. Debtor has not made any payments toward the student loans with the exception of offsets of her income tax refunds in the amount of \$3,960.95, which were credited to her student loan account. The parties have stipulated that the Direct Loans are currently eligible for participation in the Revised Pay As You Earn (hereinafter "REPAYE") income driven repayment plan, and that the FFELP Loans would also be eligible upon consolidation.⁴¹

Holding: The United States Bankruptcy Court for the District of Massachusetts held that:

Although undue hardship is not defined in the Bankruptcy Code, [the] parties have stipulated that the test to be applied in this case is the "totality of the circumstances" test, which this Court, along with the other bankruptcy courts in this district, has previously adopted.⁴² The totality of the circumstances analysis is aimed at determining the answer to the question: Can the debtor now, and in the foreseeable future, maintain a reasonable, minimal standard of living for the debtor and the debtor's dependents and still afford to make payments on the debtor's student

⁴⁰ *Parvizi v. United States Dep't of Educ.*, et al. at 2-6.

⁴¹ *Id.* at 9-10.

⁴² *Schatz v. U.S. Dep't. of Educ. (In re Schatz)*, 584 B.R. 1, 7 (Bankr. D. Mass. 2018), *vacated and remanded on other grounds*, 602 B.R. 411 (B.A.P. 1st Cir. 2019).

loans?⁴³ In answering this question, the Court should consider all relevant evidence—debtor's income and expenses, debtor's health, age, education, number of dependents and other personal or family circumstances, the amount of the monthly payment required, the impact of the general discharge under Chapter 7 and debtor's ability to find a higher-paying job, move or cut living expenses. In addition, other factors not listed here may impact a particular debtor's case.⁴⁴

Based on the totality of the circumstances, Debtor has not proven by a preponderance of the evidence that excepting her student loans from discharge would impose an undue hardship pursuant to § 523(a)(8). However, the Court does find that to the extent Debtor is unable to repay the student loans in full by the end of any applicable income-contingent repayment program, the negative amortization of the debt and accrued interest would undoubtedly constitute an undue hardship to Debtor at that time. Debtor was 51 years old at the time of trial and will be in her mid to late 70's by the time she completes an income-based repayment plan... Judgment was entered for DOE, except that pursuant to § 105(a), the Court will order that any student loan debt remaining unpaid upon Debtor's completion of the REPAYE program or any comparable program is deemed discharged as an undue hardship pursuant to § 523(a)(8).⁴⁵

d. *In re Randall*, 628 B.R. 772 (Bankr. D. Md. 2021)

Maryland Bankruptcy Court granted a partial discharge of student loans in *In re Randall*, 628 B.R. 772, (Bankr. D. Md. 2021).

Case Summary

Facts: Terry Lucille Randall (hereinafter “Plaintiff”) is 68 years old. She received her first college degree, a bachelor’s degree in psychology, in 2004 from Morgan State University. She then received a master’s degree in human services and public policy in 2008 from Sojourner-Douglass College. Plaintiff further pursued, but did not complete, a master’s degree in business administration from Strayer University. Plaintiff financed her education with assistance from her parents and with loans from, among others, Defendant. Plaintiff testified that she is currently employed as a community medical technician, earning approximately \$13 per hour with some opportunity for overtime. Plaintiff explained that she has worked an exceptional number of overtime hours during the past year primarily due to the global COVID-19 pandemic and a shortage of workers. Plaintiff stated that she did not believe her current level of overtime pay would continue after the pandemic recovery.⁴⁶

Plaintiff did not deny receiving student loans to finance her education, including student loans from Defendant in an amount now due and owing of \$190,800.35. Plaintiff further acknowledged that, with respect to the amounts due to Defendant, she has only been able to repay approximately \$3,764.43. Plaintiff lists approximately \$516,918.04 of total student loan debt in her bankruptcy schedules.⁴⁷

⁴³ *Hicks v. Educ. Credit Mgmt. Corp. (In re Hicks)*, 331 B.R. 18, 31 (Bankr. D. Mass. 2005).

⁴⁴ *Parvizi v. United States Dep’t of Educ.*, et al. at 15-16.

⁴⁵ *Id.* at 18-19.

⁴⁶ *In re Randall*, 628 B.R. 772 at 778.

⁴⁷ *Id.* at 779.

Holding: The United States Bankruptcy Court for the District of Maryland held that:

Plaintiff, within her limits, made good faith attempts to repay or otherwise address her student loan debt. The Court concluded that requiring Plaintiff to repay Defendant in full would impose an undue hardship on Plaintiff. The Court based this conclusion on, among other factors, Plaintiff's earning capacity, nominal assets, minimal existing expenses, limited opportunities for decreasing expenses or increasing wages, age, fluctuation in overtime hours and income generally, and past attempts to repay her debt given her limitations.⁴⁸ Therefore, the Court supported a finding of undue hardship. That said, "the Court did not ignore that Plaintiff has some ability to repay some portion of her student loan debt."⁴⁹ "The Code does not directly address, however, the scenario when some resources might be available to repay some of the debt but repayment of the entire debt is not possible at all, or at least not without an undue hardship."⁵⁰ "Although some courts have determined that any ability to repay requires a complete denial of discharge, the Court did not read the Code in that manner. Rather, the Court agreed with those decisions allowing a partial discharge of student loan debt when debtor has established undue hardship."⁵¹

Balancing all of the evidence and considering the language and purpose of the Code, the Court determined that Plaintiff should be required to pay a total of \$12,000 (plus interest at the federal judgment rate) to Defendant on account of the student loan debt. Plaintiff does not have to pay that amount all at once; rather, the Court found that Plaintiff should have an ability to make monthly payments towards that amount over a ten-year period. The Court recognized that such monthly payments are likely feasible for Plaintiff now but may not be so in a few years depending on Plaintiff's circumstances. As such, the Court expressly noted that Plaintiff may prepay some or all of the non-dischargeable debt she will owe to Defendant under the terms of this Court's ruling without penalty or additional interest charges. In sum, the Court ultimately held that \$12,000 of Defendant's debt is non-dischargeable under Section 523(a)(8) of the Code and that such debt shall accrue interest at the federal judgment rate until paid in full. Repaying that amount plus the remaining balance that would be due on those student loans would impose an undue hardship on Plaintiff under Section 523(a)(8) of the Code and the *Brunner* test.⁵²

e. *Homaidan v. Sallie Mae, Inc.*, 3 F.4th 595 (2d Cir. 2021)

Case held that private student loans were not excepted from discharge. *Homaidan v. Sallie Mae, Inc.*, 3 F.4th 595 (2d Cir. 2021).

Case Summary

Facts: The question in this case is whether the private educational loans that Plaintiff/Appellee Hilal K. Homaidan (hereinafter "Homaidan") took out from Defendant/Appellants Sallie Mae Inc., Navient Solutions, LLC, and Navient Credit Finance Corporation (hereinafter collectively, "Navient") were dischargeable.⁵³

⁴⁸ *Id.* at 785.

⁴⁹ *In re Randall*, 628 B.R. 772 at 785 (citing *In re Nitcher*, 606 B.R. 67, 79 (Bankr. D. Or. 2019)).

⁵⁰ *In re Randall*, 628 B.R. 772 at 785-786 (citing *Mosko v. Am. Educ. Servs.*, No. 04-52834, 2005 WL 2413582, at *8 (Bankr. M.D.N.C. Sept. 29, 2005)).

⁵¹ *In re Randall*, 628 B.R. 772 at 786 (citing *In re Alderete*, 412 F.3d 1200, 1206-07 (10th Cir. 2005)).

⁵² *In re Randall*, 628 B.R. 772 at 787-788.

⁵³ *Homaidan v. Sallie Mae, Inc.*, 3 F.4th 595 at 598.

Homaidan received the loans (hereinafter “Navient loans”), graduated from Emerson College, and later filed for Chapter 7 bankruptcy. The Bankruptcy Court’s 2009 discharge order was ambiguous as to whether the Navient loans were discharged. Navient pursued repayment after the discharge order was issued, and Homaidan complied. Among them were two direct-to-consumer Tuition Answer Loans, totaling \$12,567, from Sallie Mae Inc., a corporation to which Navient is the successor. Although the loans helped underwrite Homaidan’s college education, they were not made through Emerson’s financial aid office, nor—Homaidan alleges—were they made solely to cover Emerson’s cost of attendance. They went straight to Homaidan’s bank account, and the loan proceeds exceeded the cost of Emerson’s tuition. Soon after graduating, Homaidan filed for Chapter 7 bankruptcy in the Bankruptcy Court for the Eastern District of New York. The petition listed the Navient loans as liabilities. Homaidan eventually obtained a discharge order from the Bankruptcy Court, but the order did not specify which debts were discharged.⁵⁴

After paying off the loans in full, Homaidan reopened the bankruptcy case and commenced this adversary proceeding against Navient seeking, among other things, actual damages for Navient’s alleged violation of the discharge order. The Bankruptcy Court for the Eastern District of New York determined that the Navient loans were not excepted from discharge under 11 U.S.C. § 523(a)(8)(A)(ii) and therefore denied Navient’s motion to dismiss.⁵⁵

Navient maintains that § 523(a)(8)(A)(ii) prevented the loans from being discharged in Homaidan’s bankruptcy. That provision excepts from discharge “obligation[s] to repay funds received as an educational benefit, scholarship, or stipend.” 11 U.S.C. § 523(a)(8)(A)(ii). Under Navient’s reading of that provision, the term “educational benefit” would encompass virtually all private student loans. But that reading cannot be reconciled with the text and structure of § 523(a)(8), both of which confirm that § 523(a)(8)(A)(ii) excepts from discharge a far narrower category of debt.⁵⁶

Holding: The Second Circuit Court of Appeals, affirmed holding that:

- (1) lenders were not estopped from advancing their interpretation of the subsection of the Bankruptcy Code at issue simply because they had unsuccessfully advanced that interpretation of the provision in other cases, and
- (2) as a matter of apparent first impression for the Court, debtor’s private student loans did not constitute “funds received as an educational benefit” and so were not excepted from discharge.⁵⁷

“Educational benefit” is therefore best read to refer to conditional grant payments similar to scholarships and stipends. The Reserve Officer Training Corps and the National Health Service Corps, for example, pay tuition in exchange for a promise to serve in the military after graduation or to practice medicine in an underserved region.⁵⁸ A recipient who breaks that

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.* at 599.

⁵⁷ *Id.* at 595.

⁵⁸ *Id.* at 605 citing Jason Iuliano, *Student Loan Bankruptcy and the Meaning of Educational Benefit*, 93 AM. BANKR. L.J. 277, 292 (2019).

promise incurs an “obligation to repay [the] funds” that they previously received “as an educational benefit.” Per § 523(a)(8)(A)(ii), that obligation cannot be discharged in bankruptcy.⁵⁹

f. *McCoy v. United States of America*, 810 Fed. Appx. 315 (5th Cir. 2020)

Supreme Court denied petition for certiorari in *McCoy v. United States of America*, an appeal from the Fifth Circuit after the Acting Solicitor General filed a pleading indicating that the Education Department might revise regulations and related policies in the future. This review was started in 2018 by the Trump administration. The government also said that there were procedural problems with this appeal that would not make it appropriate for considering a nationwide standard for student loan discharge. Fifth Circuit opinion *McCoy v. United States of America*, 810 Fed. Appx. 315 (5th Cir. 2020).

Case Summary

Facts: Chapter 7 Debtor sought judgment discharging her student loan debt. After trial, the Bankruptcy Court for the Southern District of Texas declared that loans were not discharged. Debtor appealed, and the United States District Court for the Southern District of Texas affirmed. Debtor appealed to the Fifth Circuit Court of Appeals.⁶⁰

Thelma McCoy incurred a large amount of student loan debt (currently totaling over \$345,000) in pursuit of advanced degrees, beginning when she was in her forties. She consolidated her loans and entered into an income-based repayment plan. When her degrees did not yield the well-paying jobs she hoped for, she filed for bankruptcy seeking relief from the consolidated student loan debt. At the time of her bankruptcy filing, and throughout this litigation, her repayment plan has required zero dollars per month due to her low income. If her income does not improve, McCoy will continue to have a zero-dollar repayment obligation. Under the structure of the repayment plan, her debt may be forgiven twenty-five years following her first payment under the plan. See 34 C.F.R. § 685.221(f)(1), (f)(3)(ii)(D)(2013). However, under current law, such forgiveness has tax implications unless McCoy were to qualify for an employment-based exception; any forgiven amount will be subject to whatever taxation laws are in effect at the time the debt is forgiven. See 26 U.S.C. §§ 61(a)(11), 108(f)(1). Student loan debt is usually not dischargeable in bankruptcy. 11 U.S.C. § 523(a)(8). However, there is an exception, which McCoy asserted, for circumstances where failure to discharge would impose an undue hardship on Debtor. The Bankruptcy Court found no undue hardship, and the district court affirmed.⁶¹

Holding: The Fifth Circuit Court of Appeals affirmed, holding that:

The Bankruptcy Court did not clearly err in its determination that debtor's inability to pay her student loans was not likely to persist, and thus debtor was not entitled to “undue hardship” discharge of student loan debt.⁶²

The impact of a zero-dollar monthly payment under an income-based repayment plan on the first prong of *Brunner* has not been decisively determined by our court previously, and we

⁵⁹ *Homaidan v. Sallie Mae, Inc.*, 3 F.4th 595 at 605.

⁶⁰ *McCoy v. United States of America*, 810 Fed. Appx. 315 at 315-16.

⁶¹ *Id.*

⁶² *Id.*

conclude that we need not address it because McCoy has failed to establish that the bankruptcy court (as affirmed by the district court) erred in its findings on the second prong.⁶³

Under the Fifth Circuit precedent, “[a]dditional circumstances’ encompass circumstances that impacted on the debtor’s future earning potential, but which were either not present when the debtor applied for the loans or have since been exacerbated.”⁶⁴ McCoy argued that “[a]t least two major additional circumstances” demonstrate that the state of affairs is likely to persist: “(1) she is elderly—at 62 she is less than three years away from the minimum retirement age; and (2) she suffers from severe mental and physical disabilities, which are not likely to recede or resolve.”

The Bankruptcy Court determined that McCoy could not satisfy the second prong of the *Brunner* undue hardship test because, although her payments are set at zero dollars per month, she had not shown additional circumstances demonstrating her inability to pay a higher monthly amount would persist. Therefore, McCoy failed to meet her burden of proof.

In affirming the Bankruptcy Court’s determination that McCoy failed to satisfy the second prong, the District Court noted that Bankruptcy Courts have considered the timing of additional circumstances.⁶⁵ The District Court correctly determined that the Bankruptcy Court did not clearly err in its determination about the second prong of the *Brunner* undue hardship test. Accordingly, the Fifth Circuit Court of Appeals found no need to reach the third prong.

g. *In re Rosenberg*, 610 B.R. 454, 456 (Bankr. S.D.N.Y. 2020)

Chapter 7 debtor-attorney brought adversary proceeding for determination that he was entitled to ‘undue hardship’ discharge of his \$221,385.49 in consolidated student loan debt. Both parties cross-moved for summary judgment.⁶⁶

Case Summary

Facts: Debtor/Plaintiff, Kevin Jared Rosenberg, asked the Court to declare the debt owed to Educational Credit Management Corporation (hereinafter “ECMC”) dischargeable, pursuant to § 523(a)(8) in a summary judgment motion. The Bankruptcy Court for the Southern District of New York granted Plaintiff’s motion for summary judgment. However, Defendant’s cross-motion for summary judgment was denied.

Debtor filed a petition for relief under Chapter 7 of the Bankruptcy Code on March 12, 2018. On June 18, 2018, Debtor filed an adversary proceeding to have his student loan debt declared dischargeable, pursuant to 11 U.S.C. § 523(a)(8). “On November 14, 2018, the parties entered into a consent order, which authorized ECMC to intervene in this adversary proceeding as the ‘holder [] of one ... federal consolidation loan owed by Plaintiff’ (hereinafter the “Student Loan”).”⁶⁷

⁶³ *Id.* at 316-318.

⁶⁴ *Id.* at 316-17 citing *In re Gerhardt*, 348 F.3d at 92.

⁶⁵ See *In re Thoms*, 257 B.R. 144, 149 (Bankr. S.D.N.Y. 2001) (stating that a pertinent additional circumstance would be one “which was either not present when the debtor applied for the loans or has since been exacerbated” because “[o]therwise, the debtor could have calculated that factor into its cost-benefit analysis at the time the debtor obtained the loan”).

⁶⁶ *In re Rosenberg*, 610 B.R. at 454.

⁶⁷ *Id.* at 456-57.

Debtor received a discharge of his debts on July 26, 2019. ECMC filed a Cross Motion for Summary Judgement and opposition to Debtor's motion (hereinafter the "Cross Motion") on October 8, 2019. The parties agree that there are no genuine issues of material fact and that this issue is ripe for summary judgment. The Court held a hearing on October 29, 2019 and asked the parties to provide the Court with evidence as to the current promissory note, the current terms of the loan, the current principal balance, and a payment history. ECMC filed a response which contained the payment history since consolidation of the loan.⁶⁸

Debtor began borrowing money to fund his education in August 1993. From 1993 until 1996, Petitioner continued to borrow money to pay for his undergraduate education at the University of Arizona. After obtaining a Bachelor of Arts degree in History, he served in the United States Navy on active duty for five years. After completing his tour of duty, Debtor attended Cardozo Law School at Yeshiva University where he applied for and received additional student loans to cover his tuition and board from 2001 through 2004. After graduating from law school, Debtor consolidated his Student Loan on April 22, 2005 in the original principal amount of \$116,464.75. The total outstanding balance of this Student Loan as of November 19, 2019 was \$221,385.49 with an interest rate of 3.38% per annum.⁶⁹

Holding: The United States Bankruptcy Court for the Southern District of New York held that:

Debtor has a negative income each month, he has no money available to repay his Student Loan and maintain a "minimal" standard of living. This prong of the *Brunner* test is met.⁷⁰

The repayment period has ended. Debtor is in default and his loan was accelerated. As of November 19, 2019, Debtor is responsible for the repayment of the full amount of \$221,385.49. His circumstances will certainly exist for the remainder of the repayment period as the repayment period has ended and the loan is due and payable in the full amount. The second prong of the *Brunner* test is, therefore, satisfied.⁷¹

Lastly, Debtor made 10 payments, in varying amounts, during the 26 months that Debtor was responsible for making payments, which is approximately a 40% rate of payment over a thirteen-year period. Additionally, Debtor did not sit back for 20 years but made a good faith effort to repay his Student Loan. Debtor actively called and requested forbearance on at least five separate occasions, all of which were granted by the servicer.⁷²

Therefore, Debtor has demonstrated a good faith effort to repay the loan and has satisfied the "undue hardship" standard of 11 U.S.C. § 523(a)(8).⁷³

⁶⁸ *Id.* at 457.

⁶⁹ *Id.*

⁷⁰ *Id.* at 460-61.

⁷¹ *Id.* at 461.

⁷² *Id.* at 462

⁷³ *Id.*

C. Recent Law Review Article

a. ***How the Courts Have Gone Astray in Refusing to Discharge Student Loans: The Folly of Brunner, of Rewriting Repayment Terms, of Issuing Partial Discharges and of Considering Income-Based Repayment Plans*, 95 Am. Bankr. L.J. 53, 54 (2021).**

Author: Hon. Alan M. Ahart, Retired Bankruptcy Judge for the Central District of California.

Law Review Synopsis

To determine whether undue hardship exists, nine federal circuits have adopted a specious test that was promulgated in 1985 by the federal district in *Brunner v. N.Y. State Higher Educ. Services Corp. (In re Brunner)* and affirmed and adopted by the Second Circuit...This paper demonstrates how the *Brunner* undue hardship test misconstrues 11 U.S.C. § 523(a)(8) and how the courts ought to interpret this section when determining whether educational loans should be discharged in bankruptcy. Some courts have concluded that an educational loan can be partially discharged and/or restructured. This article further explains how these courts have erred. Building from different laws in two other federal circuits, this article provides the framework for determining whether an educational loan should be discharged.⁷⁴

The article concludes by pointing out that: “[t]he Courts of Appeals in all, but two federal circuits have adopted the *Brunner* test to determine whether an educational loan should be discharged under § 523(a)(8).”⁷⁵ The article further indicates the [t]hree elements of the *Brunner* test are wide of the mark: a bankruptcy court should not be required to demonstrate a “certainty of hopelessness,” “extraordinary circumstances,” or that her situation will persist for a long time, or that she has made good faith efforts to repay the loan. Many courts in these *Brunner* circuits have rewritten the repayment terms and/or ordered these loans partially discharged. Other courts in various federal circuits have considered the debtor’s eligibility to participate in an income-based repayment plan when deciding whether an educational loan should be discharged.⁷⁶ Judge Ahart asserts these actions are mistaken.

According to Judge Ahart, “a bankruptcy court must decide whether the debtor’s reasonable future financial resources would [adequately] cover payment of the student loan debt over the remaining term of the loan, while still permitting for a minimal standard of living.”⁷⁷ However, if the court does not find “undue hardship” then the student loan should not be discharged.⁷⁸ Thus, a money judgment must be entered in favor of the creditor.⁷⁹ On the other hand, if the court determines that “undue hardship” is established then the court ought to simply order a discharge of the entire balance of the student loan.⁸⁰

⁷⁴ Alan M. Ahart, *How the Courts Have Gone Astray in Refusing to Discharge Student Loans: The Folly of Brunner, of Rewriting Repayment Terms, of Issuing Partial Discharges and of Considering Income-Based Repayment Plans*, 95 Am. Bankr. L.J. 53, 54 (2021).

⁷⁵ *Id.* at 78-79.

⁷⁶ *Id.* at 79

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

A COUPLE OF OFTEN MISUNDERSTOOD RULES OF EVIDENCE

Hon. Kimberley H. Tyson
United States Bankruptcy Judge
District of Colorado

I. TO TAKE JUDICIAL NOTICE OR NOT – THAT IS THE QUESTION.

Rule 201. Judicial Notice of Adjudicative Facts

- (a) *Scope*. This rule governs judicial notice of an adjudicative fact only, not a legislative fact.
- (b) *Kinds of Facts That May Be Judicially Noticed*. The court may judicially notice a fact that is not subject to reasonable dispute because it:
 - (1) is generally known within the trial court's territorial jurisdiction; or
 - (2) can be accurately and readily determined from sources whose accuracy cannot reasonably be questioned.
- (c) *Taking Notice*. The court:
 - (1) may take judicial notice on its own; or
 - (2) must take judicial notice if a party requests it and the court is supplied with the necessary information.
- (c) *Timing*. The court may take judicial notice at any stage of the proceeding.
- (d) *Opportunity to Be Heard*. On timely request, a party is entitled to be heard on the propriety of taking judicial notice and the nature of the fact to be noticed. If the court takes judicial notice before notifying a party, the party, on request, is still entitled to be heard.
- (f) *Instructing the Jury*. In a civil case, the court must instruct the jury to accept the noticed fact as conclusive. In a criminal case, the court must instruct the jury that it may or may not accept the noticed fact as conclusive.

Judicial notice applies only to adjudicative facts. The usual method of establishing adjudicative facts is through the introduction of evidence, ordinarily consisting of the testimony of witnesses. If particular facts are outside of reasonable controversy, this process may be dispensed with as unnecessary. A high degree of indisputability is the essential prerequisite.

With respect to judicial notice of adjudicative facts, the tradition has been one of caution in requiring that the matter be beyond reasonable controversy. The rule proceeds upon the theory that dispensing with traditional methods of proof is appropriate only in clear cases.

Under subdivision (c) a judge has a discretionary authority to take judicial notice, regardless of whether he is so requested by a party. The taking of judicial notice is mandatory, under subdivision (d), only when a party requests it and the necessary information is supplied.

Attorneys tend to attempt to fill in holes in their cases by asking the Court to take judicial notice of pleadings file in the case. For example, judges are asked to take judicial notice of a debtor's schedules in the Court's file. The Court can take judicial notice of the fact that on a date specific someone filed Schedules A-J bearing the debtor's name and that those schedules contain certain representations. But when a court takes judicial notice of the fact that Schedule I indicates the debtor earns \$2,000 per month, it does not mean the debtor has proven he does, in fact, earn \$2,000 per month. All it means is the Court observed what anyone else could observe, i.e., that there is a document on file that says so.

II. SINCE THE DOCUMENT WAS KEPT BY A BUSINESS, ISN'T IT A BUSINESS RECORD?

Rule 803. Exceptions to the Rule Against Hearsay

The following are not excluded by the rule against hearsay, regardless of whether the declarant is available as a witness:

...

(6) *Records of a Regularly Conducted Activity.* A record of an act, event, condition, opinion, or diagnosis if:

- (A) the record was made at or near the time by — or from information transmitted by — someone with knowledge;
- (B) the record was kept in the course of a regularly conducted activity of a business, organization, occupation, or calling, whether or not for profit;
- (C) making the record was a regular practice of that activity;
- (D) all these conditions are shown by the testimony of the custodian or another qualified witness, or by a certification that complies with Rule 902(11) or (12) or with a statute permitting certification; and
- (E) the opponent does not show that the source of information or the method or circumstances of preparation indicate a lack of trustworthiness.

(7) *Absence of a Record of a Regularly Conducted Activity.* Evidence that a matter is not included in a record described in paragraph (6) if:

- (A) the evidence is admitted to prove that the matter did not occur or exist;
- (B) a record was regularly kept for a matter of that kind; and
- (C) the opponent does not show that the possible source of the information or other circumstances indicate a lack of trustworthiness.

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The so-called “business record” exceptions proceed upon the theory that under appropriate circumstances a hearsay statement may possess circumstantial guarantees of trustworthiness sufficient to justify nonproduction of the declarant in person at the trial even though he may be available.

In a hearsay situation, the declarant is, of course, a witness, and neither this rule nor Rule 804 dispenses with the requirement of firsthand knowledge. It may appear from his statement or be inferable from circumstances.

F.R.E. 803(6) and (7) arise largely within the context of business and commercial records. The element of unusual reliability of business records is said variously to be supplied by systematic checking, by regularity and continuity which produce habits of precision, by actual experience of business in relying upon them, or by a duty to make an accurate record as part of a continuing job or occupation.

Amplification of the kinds of activities producing admissible records has given rise to problems which conventional business records by their nature avoid. They are problems of the source of the recorded information, of entries in opinion form, of motivation, and of involvement as participant in the matters recorded.

Sources of information presented no substantial problem with ordinary business records. All participants, including the observer or participant furnishing the information to be recorded, were acting routinely, under a duty of accuracy, with employer reliance on the result, or in short “in the regular course of business.”

The form which the “record” may assume under the rule is described broadly as a “memorandum, report, record, or data compilation, in any form.” The expression “data compilation” is used as broadly descriptive of any means of storing information other than the conventional words and figures in written or documentary form. It includes, but is by no means limited to, electronic computer storage. Failure of a record to mention a matter which would ordinarily be mentioned may be satisfactory evidence of its nonexistence.

The fact that someone at a business wrote a letter to someone, or made a notation, or created a document, or kept a letter in a business file, does not make that letter or notation or document a “business record” as it is not a record of a regularly conducted activity. To be admissible, there are five requirements: (a) the record has to be made at or near the time of the activity to which it relates took place; (b) it has to be made by a person with knowledge; (c) it has to be kept in the course of a regularly conducted business activity; and (e) the person who has to prove all that must be the “custodian” of those records.

Faculty

Hon. Robert D. Berger was appointed as a U.S. Bankruptcy Judge for the District of Kansas in Kansas City on Oct. 16, 2003, and was reappointed on Oct. 16, 2017. Prior to his appointment, Judge Berger practiced law as a bankruptcy and insolvency specialist representing debtors and creditors, and was among the first group of attorneys in Kansas and Missouri to be certified by the American Board of Certification in both consumer and business bankruptcy law. Judge Berger is a member of ABI and the National Conference of Bankruptcy Judges, and a founding member of the Kansas Chapter of the Federal Bar Association. He also is a chapter and section author for *Collier on Bankruptcy* and the *Collier Bankruptcy Practice Guide*, and has authored articles for various publications, including *The Washburn Law Journal*, the *American Bankruptcy Institute Journal* and the *Journal of the Kansas Bar Association*. In addition, he is co-editor of the Kansas Bar Association's *Family Law Handbook* chapter on bankruptcy and has served as a frequent lecturer on bankruptcy, insolvency and related tax issues. Judge Berger received his B.A. in history and political science from the University of Kansas in 1983 and his J.D. from Washburn University School of Law in 1986.

Hon. Ashely M. Chan is a U.S. Bankruptcy Judge for the Eastern District of Pennsylvania in Philadelphia. Prior to taking the bench, she was a shareholder at Hangley Aronchick Segal Pudlin & Schiller and concentrated her practice in the areas of bankruptcy and corporate restructuring. From 1996-97, Judge Chan clerked for Hon. Gloria M. Burns of the U.S. Bankruptcy Court for the District of New Jersey. Before joining HASPS, she was an associate at Morgan, Lewis & Bockius LLP in its business and finance section, where she focused on bankruptcy, corporate restructuring and corporate finance. Judge Chan has received numerous recognitions, including being selected as a Leader in Bankruptcy/Restructuring by *Chambers USA*, being listed in *The Best Lawyers in America* for Bankruptcy and Creditor-Debtor Rights, and being listed as a Pennsylvania Lawyer on the Fast Track by *The Legal Intelligencer* and *Pennsylvania Law Weekly*. She also served as chair of the Eastern District of Pennsylvania Bankruptcy Conference and president-elect and board member of the Homeless Advocacy Project. Judge Chan received her J.D. in 1996 from Rutgers School of Law – Camden, where she received Tax Honors with Distinction and the Rutgers Pro Bono Publico Award.

Hon. Clifton R. Jessup, Jr. is a U.S. Bankruptcy Judge for the Northern District of Alabama in Decatur, appointed on March 2, 2015. He was formerly a principal shareholder in the Dallas office of the international law firm of Greenburg Traurig, LLP where he concentrated his practice in business reorganization and bankruptcy. During his more than 35 years of bankruptcy-related practice before taking the bench, Judge Jessup represented secured creditors, unsecured creditors, committees, equity-holders, debtors and trustees in federal bankruptcy cases in more than 37 states and Puerto Rico. He also represented purchasers of assets in bankruptcy cases, and served as examiner and mediator in many cases. In 2001, Judge Jessup was selected as the liquidating trustee under the confirmed chapter 11 plan in the Baptist Foundation of Arizona, the largest nonprofit bankruptcy cases filed to date. The cases involved more than 13,000 investors and claims in excess of \$600 million. In 2009, he represented the Opus West Corp. in a chapter 11 case involving more than 50 commercial real estate properties in California and Texas with claims in excess of \$1.2 billion. Judge Jessup is a member of the Advisory Committee to ABI's Commission to Study the Reform of Chapter 11 and of the Texas State Bar. He received his J.D. in 1978 from the University of Michigan.

Hon. Christopher M. López is a U.S. Bankruptcy Judge for the Southern District of Texas in Houston, sworn in on Aug. 14, 2019. He was previously counsel in the Business, Finance and Restructuring Department of Weil, Gotshal & Manges and had been involved in a number of significant chapter 11 cases in Houston and across the country. Judge López is a member of the State Bar of Texas and the Houston Bar Association. He is also a member of the Honorable Arthur L. Moller/David B. Foltz, Jr. American Inn of Court and has studied cross-border and banking issues in Mexico. Judge López is a member of the board of directors of the Hispanic Bar Association of Houston. He received his B.A. in psychology in 1996 from the University of Houston, his M.A. in theology in 1999 from Yale University and his J.D. in 2003 from the University of Texas School of Law, where he was a member of the *Texas International Law Journal* and elected permanent class president for the class of 2003.

Hon. Cynthia A. Norton is a U.S. Bankruptcy Judge for the Western District of Missouri in Kansas City. Prior to her appointment, she was a founding partner of Grimes & Rebein, LC in Lenexa, Kan., where she focused on consumer and business bankruptcy, creditors' rights, commercial workouts and related fields. She also clerked for Hon. John E. Rees of the Kansas Court of Appeals and Hon. James A. Pusateri of the U.S. Bankruptcy Court in Topeka, Kan., and was previously an associate with Stinson, Mag & Fizzell, an associate and then partner with Lewis, Rice & Fingers, and Of Counsel with Levy & Craig. She has published an annual column reviewing Eighth Circuit bankruptcy cases of interest for *Norton's Bankruptcy Law Advisor* and has authored numerous articles, book chapters and seminar papers on bankruptcy-related topics, is a Fellow in the American College of Bankruptcy and is a member of various bankruptcy organizations. She is the recipient of the Michael R. Roser Excellence in Bankruptcy Award and the Robert L. Gernon Award for Outstanding Contribution to CLE. Judge Norton received her B.A. in French and art history Phi Beta Kappa and *summa cum laude* from Kansas University and her J.D. from the Kansas University Law School, where she was associate editor of its law review.

Hon. Karen B. Owens is a U.S. Bankruptcy Judge for the District of Delaware in Wilmington. Prior to her appointment, she was a director in the Bankruptcy and Insolvency group of Ashby & Geddes, P.A., where she maintained a diverse practice, representing corporate debtors, estate professionals, various secured and unsecured creditor constituencies, and other interested parties in reorganization and liquidation proceedings and bankruptcy-related litigation. Prior to joining Ashby & Geddes, Judge Owens started her career at Skadden, Arps, Slate, Meagher & Flom as a corporate restructuring associate, and later went on to clerk for Hon. Brendan Linehan Shannon of the U.S. Bankruptcy Court for the District of Delaware. She received her Bachelor's degree from Pennsylvania State University, where she was Phi Beta Kappa, and her J.D. *summa cum laude* from American University's Washington College of Law, where she served as an associate managing editor for the *American University Law Review* and as legal intern to Hon. Stephen S. Mitchell of the U.S. Bankruptcy Court for the Eastern District of Virginia.

Hon. Anita L. Shodeen is a U.S. Bankruptcy Judge for the Southern District of Iowa in Des Moines, appointed in 2009. She also serves on the Eighth Circuit Bankruptcy Appellate Panel, is a member of the Judicial Resources Committee of the Judicial Conference, and is a Fellow in the American College of Bankruptcy. Judge Shodeen is an associate editor for the *American Bankruptcy Law Journal*. Prior to her appointment, she focused her practice on representing both debtors and creditors in workouts, bankruptcy and litigation in the state and federal courts. She also served as a chapter 7

panel trustee and chapter 12 standing trustee. Judge Shodeen received her J.D. in 1985 from Drake University.

Hon. Kathy A. Surratt-States is Chief Bankruptcy Judge for the Eastern District of Missouri in St. Louis, initially appointed on March 17, 2003, and named Chief Judge on Feb. 1, 2013. She is the first African-American appointed to the bankruptcy bench in the Eighth Circuit. Judge Surratt-States began her legal career as law clerk to now-retired Bankruptcy Judge James J. Barta. In 1993, she was an associate at Campbell & Coyne, P.C., where her work focused on bankruptcy, commercial litigation and foreclosures. She then moved to Ziercher & Hocker, P.C. in 1998, where she became partner. The firm later merged with Husch Blackwell, where she was a partner in its insolvency practice group until her appointment to the bankruptcy court. In 1997, Judge Surratt-States was appointed to the Panel of Bankruptcy Trustees for the Eastern District of Missouri, and in 1999, she served as the chapter 7 trustee for Family Company of America, then the third-largest grocery store chain in St. Louis. Judge Surratt-States serves on the Board of Catholic Charities of St. Louis and is a member of Altrusa International, Inc. of St. Louis, an international association of professionals dedicated to serving their community. She also is a member of the Missouri Bar, the Bar Association of Metropolitan St. Louis, the Mound City Bar Association, the National Conference of Bankruptcy Judges, ABI and the International Women's Insolvency & Restructuring Confederation (IWIRC). Judge Surratt-States received her B.A. *cum laude* from Oklahoma City University in 1988 and her J.D. from Washington University School of Law in 1991.

Hon. Kimberley H. Tyson is Chief U.S. Bankruptcy Judge for the District of Colorado in Denver, initially appointed to the bench in May 2017. Previously she was a director of Ireland Stapleton Pryor & Pascoe, PC, where her practice focused on bankruptcy and related litigation. She represented secured and unsecured creditors, creditors' committees, trustees and purchasers in bankruptcies, as well as clients in contested foreclosure proceedings and lender-liability cases. She also pursued hidden or improperly transferred assets. In March 2011, she was appointed to the panel of chapter 7 trustees by the U.S. Trustee. Ms. Tyson is a former chair of the Colorado Bar Association's Bankruptcy subcommittee and is a frequent lecturer on bankruptcy issues, co-authors the bankruptcy chapter of the *Annual Survey of Colorado Law*, and has been named in *Colorado Super Lawyers*. She is an active member of ABI, having served on its Rocky Mountain Bankruptcy Conference advisory board since 2003. Ms. Tyson clerked for Hon. John K. Pearson of the U.S. Bankruptcy Court for the District of Kansas and Hon. Jerry G. Elliot of the Kansas Court of Appeals. She earned her B.A. at Smith College and her J.D. at the University of Kansas School of Law.