2017 Rocky Mountain Bankruptcy Conference

Roundtable Discussions on the Supreme Court

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Supreme Court Cases: Recent Decisions and Coming Attractions

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Supreme Court: Upcoming Attractions

Casimir Cryzewski et al. v. Jevic Holding Corp., et al, No. 15-649 (U.S. argued Dec. 7, 2016).

Question presented:

Whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme.

Background Facts:

Jevic Transportation, Inc. was a trucking company headquartered in New Jersey. In 2006, after Jevic's business began to decline, a subsidiary of Sun Capital Partners acquired the company in a leveraged buyout financed by a group of lenders led by CIT Group. The company continued to struggle, and in May 2008, Jevic's board of directors authorized a bankruptcy filing. The company ceased substantially all of its operations, and its employees received notice of their impending terminations on May 19, 2008. The next day, Jevic filed a voluntary Chapter 11 petition in the United States Bankruptcy Court for the District of Delaware.

Two lawsuits were filed in the Bankruptcy Court. First, a group of Jevic's terminated truck drivers (Drivers) filed a class action against Jevic and Sun alleging violations of federal and state Worker Adjustment and Retraining Notification (WARN) Acts, under which Jevic was required to provide 60 days' written notice to its employees before laying them off. Additionally, the Committee brought a fraudulent conveyance action based upon the leveraged buyout against Sun and CIT.

Ultimately, the Committee, Jevic, CIT and Sun reached a settlement agreement. At that time Jevic's only remaining assets were $1.7 million in encumbered cash and the fraudulent conveyance action. The terms of the settlement were: (i) mutual releases and dismissal of the fraudulent conveyance action; (ii) CIT would pay $2 million which was earmarked to pay Javic's and the Committee's legal fees and other administrative expenses; (iii) Sun would assign it lien on the $1.7 million in cash to a trust to pay tax and administrative creditors, and then general unsecured creditors on a pro rata basis; and (iv) the case would be dismissed.

The issue that arose under the structured settlement is that the Drivers were to receive nothing on their priority wage claims, but the lower-priority general unsecured creditors were to be paid by the estate. The reason that the settlement agreement skipped the Drivers is that CIT/Sun did not want to "fund" the ongoing class action lawsuit asserted by the Drivers against them for violations of the WARN Acts.

Bankruptcy Court:

The bankruptcy court approved the settlement and the "structured" dismissal of the bankruptcy case over the Drivers' objection. In doing so, the bankruptcy court made very detailed factual findings supporting its ruling. First, the Court found that there was "no prospect" of a confirmable Chapter 11 plan being filed. And, conversion to liquidation under Chapter 7 of the

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Bankruptcy Code would have been unavailing for any party because a Chapter 7 trustee would not have had sufficient funds "to operate, investigate or litigate" (since all the cash left in the estate was encumbered) and the secured creditors had "stated unequivocally and credibly that they would not do this deal in a Chapter 7." The court also found that without the settlement that the possibility of a recovery on the fraudulent conveyance action was remote at best, as there were "several independent hurdles that the Committee would have to clear before it would actually see a material recovery out of the litigation," which would take years. The settlement met the paramount interests of the creditors as it provided a substantial distribution to administrative and unsecured creditors and the Drivers' claim against the estate was "effectively worthless given that the estate lacks available unencumbered funds to satisfy it if it were allowed." The settlement was fair and equitable as all major stakeholders were involved in the negotiations (including the Drivers), the committee lacked the resources to go forward, and it provided for a meaningful distribution to creditors that they would otherwise not receive. The bankruptcy court also found that conversion to chapter 7 did not provide a better option as any attorney would be crazy to take the fraudulent conveyance case on a contingency fee basis: "any lawyer or firm that signed up for that role should have his head examined."

The Drivers did not obtain a stay of the settlement pending appeal, the settlement was consummated with thousands of checks distributed to unsecured creditors, and the bankruptcy was dismissed. On appeal, the District Court dismissed the appeal and affirmed the order of the bankruptcy after concluding that the appeal was equitably moot in light of the settlement.

The Third Circuit:

The Third Circuit also affirmed in a divided opinion. *Official Comm. of Unsecured Creditors v. CIT Grp/Bus. Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3rd Cir. 2015). Although the majority was troubled by the structured dismissal's departure from priority, noting that "[s]ettlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals," it reasoned that the absolute priority rule codified in §1129(b)(2) applies by its terms to plans, and that no Code provision explicitly prohibits priority-skipping distributions of settlement proceeds made outside a plan. *Id.* at 183-85.

Further, the majority recognized that two other courts of appeals had reached divergent results on the issue of whether settlement proceeds could be distributed without following the priority scheme in the Code, and opted to follow the more "flexible" approach adopted by the Second Circuit in *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Op. LLC)*, 478 F.3d 452 (2nd Cir. 2007) as opposed to the absolute prohibition on such a practice per the Fifth Circuit in *In re AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984). Thus, the Third Circuit held that settlements that "distribut[e] estate assets" but "deviate from the priority scheme" may be approved under Rule 9019 in "rare instances," if the bankruptcy court has "specific and credible grounds to justify [the] deviation." *Id.* at 184. The majority found such grounds, endorsing the bankruptcy court's view that the settlement and structured dismissal were the "least bad alternative." *Id.* at 185.

Judge Scirica dissented. For the dissent, the facts at issue were not sufficient to justify a departure from the Bankruptcy Code's core goals. Specifically, the settlement raised the same concerns as a *sub rosa* plan in that "[t]he settlement reallocated assets of the estate in a way that would not have been possible without the authority conferred upon the creditors' committee by Chapter 11 and effectively terminated the Chapter 11 case, but it failed to observe Chapter 11's safeguards of disclosure, voting, acceptance, and confirmation." *Id.* at 188. Thus, the settlement constituted an "impermissible end-run around the carefully designated routs by which a debtor may emerge from Chapter 11 proceedings." *Id.* Finally, the dissent did not believe that the circumstances present in this case were, in fact, so "rare:" it was not difficult to imagine circumstances in which a settling creditor would want to avoid payments to certain unsecured creditors. *Id.* at 190.

The Supreme Court:

The Supreme Court granted *certiorari*.

In their briefs, the Drivers argued that nowhere in the Code is there any authority for the Bankruptcy Court to allow a "structured dismissal" which disregards the priority scheme over the objection of the injured party. Distributions can only occur pursuant to a plan or in a chapter 7, they must comply with 11 U.S.C. § 507. The overall structure of the Bankruptcy Code forecloses a priority-skipping structured dismissal. A contrary rule would invite collusion to squeeze out disfavored creditors.

In response, the Respondents argued that the Bankruptcy Code neither authorizes nor requires bankruptcy courts to reject chapter 11 settlements that do not follow the Code's priority scheme. Specifically, they claimed that the priority scheme simply does not apply to chapter 11 settlements.

Amicus briefs were filed on behalf of the Petitions by the United States, the Loan Syndications and Trading Association, National Employment Law Project, Law Professors and Illinois. The Loan Syndication group argued that the lending market relies upon predictability, certainty and reliability, and priority-skipping settlements undermine the predictability on which commercial lending markets depend. The National Employment Law Project argued that evasion of obligations to employees and customers is a common and growing motivation for, and strategy in, corporate bankruptcies and that the Bankruptcy Code's priority scheme is an essential protection against wage theft and other such abuses.

At oral argument, the Petitioners were asked how a reversal would benefit the Drivers given the bankruptcy court's factual findings that they had no avenue for recovery. Counsel suggested that in a Chapter 7 case the fraudulent transfer might be pursued by contingency counsel, or, if no contingency fee arrangements could be made, the claims could be abandoned back to the Drivers.

Responding to the argument that Congress never intended for settlements and dismissal to be a distributional process, Justice Kennedy noted that the "for cause" exception in the dismissal statute at 11 U.S.C. § 349(b) appears to authorize the bankruptcy court to alter the effect of dismissal from merely restoring the pre-bankruptcy status quo. Counsel responded by claiming

that the "for cause" exception was intended to give the bankruptcy court discretion to protect third-party detrimental reliance on intervening bankruptcy court orders, not to reorder distributional priorities.

Justice Kagan then asked how broadly or narrowly the court might rule, should it reverse. Counsel limited the relief sought to a rejection of a priority-deviating case resolution through a structured-dismissal order. Counsel distinguished the relief from the "doctrine of necessity" upon which courts rely to approve critical vendor orders, and specifically stated that that issue was not before the court.

Counsel for Jevic faced extensive questioning from the justices. He argued that the bankruptcy court had authority to approve the structured settlement under 11 U.S.C. 363, but ultimately conceded that compliance with bankruptcy-code priorities is the most important factor informing the bankruptcy court's discretion under Section 363. Only a "rare" case such as this one warrants bankruptcy-court approval of a priority deviation in a settlement. The justices, however, seemed unconvinced that this was a "rare" case. Chief Justice Roberts observed to respondents' counsel that "the reasonableness of your position is directly related to how extraordinary the extraordinary circumstances have to be."

Result:

A ruling is anticipated in the first quarter of 2017. Many prognosticators have opined that the Supreme Court will reverse on a narrow basis that only prohibits the distribution of settlement proceeds in a manner that violates the statutory priority scheme as opposed to a flat prohibition on any distribution that violates the priority scheme. If the Court does not reverse, it may attempt to define the "rare" circumstances in which such a distribution would be appropriate.

HUSKY

A MAJOR BREAK THROUGH IN THE LAW OF FRAUD OR IS THE CASE JUST ANOTHER DOG?

BY RON PETERSON
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When I went to law school, I was taught that fraud was: a knowing and material misrepresentation of a material fact, done by one who knew the fact was false and made the representation with the intent that the recipient rely. Moreover, the recipient of the representation needed to show that he reasonably or justifiably relied on the representation and that reliance was the proximate cause of foreseeable damages. The key to understanding fraud was there had to a misrepresentation or a failure to disclose when under a duty to do so. So much for what I learned in law school.

The cracks in this definition started in July 2000, when the Court of Appeals for the Seventh Circuit in *McClellan v. Cantrell*, 217 F.3d 890 (7th Cir. 2000) took a new look at what actual fraud really mean. McClellan, the creditor, sold his business assets, consisting of ice-making machinery, to the debtor's brother for $200,000.00, payable in installments. McClellan retained but did not perfect a security interest in the machinery. The brother defaulted and McClellan sued the debtor's brother in the Illinois state court that sought, among other things, an injunction against the brother transferring the ice making machinery. While the lawsuit was pending, the brother sold the ice making machinery to the debtor for $10.00. The sister/debtor knew all about the lawsuit and turned around and sold the machine for $160,000.00. As Judge Posner noted, "she is not telling anyone what has happened to that money."

McClellan added the sister to his lawsuit and while the case was pending, the sister filed for bankruptcy. McClellan, in turn, objected to her discharge on the grounds that she had

committed an act of actual fraud under 11 U.S.C. § 523(a)(2). Under my law school understanding of fraud, McClellan was out of luck—there was never a communication, let alone a misrepresentation, between the sister/debtor and McClellan. The bankruptcy court and the district court saw the law the same way and holding that the sister had not committed fraud because there was no evidence of representation by the debtor. Moreover, both courts interpreted the Supreme Court's decision in *Field v. Mans*, 516 U.S. 59 (1995), as requiring by implication the allegation of a communication to support a viable fraud claim.

The Seventh Circuit disagreed. First, the court distinguished *Field v. Mans*, by stating that the *Field* case only dealt with fraud where there was a misrepresentation. The court rejected the interpretation that *Field* stands for the proposition that every type of fraud must include a misrepresentation—"fraud" is not so limited. In support of this proposition, the Seventh Circuit quoted the Oklahoma Supreme Court, which held:

> Fraud is a generic term, which embraces all the multifarious means which human ingenuity can devise and which are resorted to by one individual to gain an advantage over another by false suggestions or by the suppression of truth. No definite and invariable rule can be laid down as a general proposing defining fraud, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated. *Stapleton v. Holt,* 207 Oks 443, 250 N.Ed.2d 451 (1952).

The debtor argued that the she had nothing to do with the original transaction between her brother and McClellan, and, therefore, could not have obtained, by fraud, a debt of McClellan. In dealing with the language of the statute, the court held that there were really two debts. The first debt was the debt between McClellan and the debtor's brother. The second debt was created when the debtor participated in the fraud with her brother against McClellan. Thus, the sister/debtor obtained or incurred a debt to McClellan through her nefarious activities with her brother. Consequently, the Seventh Circuit reversed the bankruptcy court's decision dismissing

McClellan's complaint and allowed him to go about the business of trying to prove that his fraud allegations were true.

Outside of the Seventh Circuit, the issue of actual fraud remained pretty quiet until the 2009 *Husky International Electronic, Inc v. Ritz*, 136 S.Ct. 1581 (2016) discharge litigation. The story starts with Husky International Electronics, Inc., a Colorado-based supplier of components used in electronic devices. Between 2003 and 2007, Husky sold its products to Chrysalis Manufacturing. Chrysalis incurred a debt to Husky of $163,999.38. During the same period, Daniel Ritz served as a director of Chrysalis and owned at least 30% of Chrysalis' common stock. Between 2006 and 2007, Ritz drained Chrysalis of assets it could have used to pay its debts to creditors by transferring large sums of Chrysalis' funds to other entities Ritz controlled. In 2009, Ritz filed for relief under Chapter 7 of the Bankruptcy Code. Husky filed a complaint against Ritz that sought, among other things, a holding that Ritz debt to Husky was not dischargeable because Ritz's use of Husky's funds constituted "actual fraud" under §523(a)(2)(A). The bankruptcy court held that the debt was dischargeable because nothing in the record supported a finding that Ritz made a misrepresentation to Husky and the district court and the Fifth Circuit affirmed.

The U.S. Supreme Court reversed. The Court found that the Bankruptcy Code of 1978 had added "actual fraud" to the law, something that was missing from the Act of 1898. The Court presumed that Congress meant that addition to change the status of the law. In other words, the addition of "actual fraud" to the statute has some impact. Consequently, "actual fraud" could not require the existence of a misrepresentation because under that interpretation Congress' amendment added nothing given a misrepresentation was already in the statute and a grounds for finding a debt to be non-dischargeable.

Instead, the Court found that "actual fraud" has a very broad definition and includes a transfer of assets made with the actual intent to delay, hinder or defraud. The Court also rejected Ritz's argument that he was not an obligee of the original debt between Husky and Chrysalis and could not have obtained a debt he did not owe by fraud. In rejecting that argument, the Court followed the holding in *McClellan v. Cantrell*, and held that the debtor's knowing participation in an actual fraudulent transfer creates a new debt which is not subject to discharge.

What are the ramifications of this decision? The decision may have a broader impact than just affecting an 11 U.S.C. § 523(a)(2) discharge case. For example, if a trustee sues a party who received a transfer made by the debtor with the actual intent to delay, hinder and defraud and that party had actual or possibly inquiry notice of the fraudulent nature of the transfer, then the trustee also could sue the target for fraud and seek punitive damages. *Husky* then may be a workaround for a defendant that would otherwise have a good defense under 11 U.S.C. § 546(e). Further, a trustee may be able to recover against a defendant if the nefarious conduct did not contain a misrepresentation, but caused an injury or allowed another an unfair advantage. On the other hand, many judges are wed to the old definition of fraud and may limit *Husky* to 11U.S.C. § 523(a)(2) actions, and render *Husky* just another dog.

Eight (or So) Important Supreme Court Cases

(Adapted from the National Conference of Bankruptcy Judges' Roundtable October 28, 2016)

Local Loan Co. v. Hunt, 292 U.S. 234 (1934):

Whether a bankruptcy court has the authority to enjoin post-discharge prosecution of a state court by a creditor to enforce a prepetition assignment of a debtor's wages.

Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935):

Can laws passed pursuant to the Bankruptcy Clause of the Constitution of the United States override the provisions of the Taking Clause of the Constitution of the United States to impair rights of a secured creditor without "just compensation?"

Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106 (1939):

The rejection of the relative priority rule, the clear and "absolute" endorsement of the absolute priority rule and the genesis of the new value exception to the absolute priority rule for purposes of a "fair and equitable" plan of reorganization.

ule, a "stockholder's

Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950):

Whether the notice requirements for investment trustees with regard to known and unknown beneficiaries under New York law was compatible with the Fourteenth Amendment of the Constitution of the United States.

Butner v United States, 440 U.S. 48, 99 S. Ct. 914 (1979):

Are property rights in bankruptcy cases determined by a federal rule of equity or by the law of the location of the property?

Till v. SCS Credit Corp., 541 U.S. 465 (2004):

What is the proper method for adjusting payments to a creditor to arrive at the present value of an allowed secured claim in a Chapter 13 cramdown?

Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982); ***Stern v. Marshall***, 564 U.S. 462 (2011); ***Executive Benefits Ins. Agency v. Arkison***, 134 S. Ct. 2165 (2014); ***Wellness Int'l Network, Ltd. v. Sharif***, 135 S. Ct. 1932 (2015):

Do bankruptcy statutes (28 U.S.C. § 1471 and 28 U.S.C. § 157) unconstitutionally confer Article III judicial power on non-Article III judges?

Law v. Siegel, 134 S. Ct. 1188 (2014):

May a bankruptcy court order otherwise exempt assets to be used to pay administrative expenses incurred as a result of the debtor's misconduct?

Coming Attractions: Circuit Splits and Diverging Authorities

Enforcement of Non-debtor Releases or "Bar Orders" in Chapter 11 Plans

Allowing non-debtor releases: *SE Property Holdings, LLC v. Seaside Engineering & Surveying, Inc. (In re Seaside Engineering & Surveying, Inc.)*, 780 F.3d 1070 (11th Cir. 2015); *In re Airadigm Comm., Inc.*, 519 F.3d 640 (7th Cir. 2008); *In re Dow Corning Corp*., 280 F.3d 648 (6th Cir. 2002); In re Drexel Lambert Group, Inc., 960 F.2d 285 (2d Cir. 1992); *In re A.H. Robins Co*., 880 F.2d 694 (4th Cir. 1989); *cf. In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000) (discussing but declining to adopt per se rule in favor of non-debtor releases).

Non-debtor releases improper: *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592 (10th Cir. 1990).

Bankruptcy Court as a "court of the United States" for Sanctions Under **28 U.S.C. § 1927**

No authority to award sanctions under 28 U.S.C. § 1927: *Jones v. Bank of Santa Fe (In re Courtesy Inns, Ltd.)*, 40 F.3d 1084 (10th Cir. 1994); *see Perroton v. Gray (In re Perroton)*, 958 F.2d 889 (9th Cir. 1992) (bankruptcy court is not "court of the United States" for fee waivers under 28 U.S.C. § 1915); *see also Determan v. Sandoval (In re Sandoval)*, 186 B.R. 490 (B.A.P. 9th Cir. 1995) (following *Perroton* to preclude sanctions under 28 U.S.C. § 1927); *cf. Brown v. Mitchell (In re Arkansas Communities, Inc.)*, 827 F.2d 1219 (8th Cir. 1987) (noting "that it is questionable whether a bankruptcy court falls within the definition of 'courts of the United States' for purposes of imposing sanctions" under statute).

Sanctions under 28 U.S.C. § 1927 Permissible: *In re Schaefer Salt Recovery, Inc.*, 542 F.3d 90 (3d Cir. 2008); *Adair v. Sherman*, 230 F.3d 890 (7th Cir. 2000); *Baker v. Latham Sparrowbush Assoc. (In re Cohoes Indus. Terminal, Inc.)*, 931 F.2d 222 (2d Cir. 1991); *see also Grossman v. Wehrle (In re Royal Manor Mgmnt., Inc.)*, 652 Fed. App. 330 (June 15, 2016) (unpublished) (concluding that bankruptcy courts have statutory authority for sanctions, but noting that no published Sixth Circuit opinions have recognized as much).

Dischargeability of Tax Debts **under 11 U.S.C. § 523(a)(1); Late Filed "Returns" under BAPCPA**

Taxpayer's subjective intent concerning filing delinquency irrelevant: *In re Colson*, 446 F.3d 836 (8h Cir. 2006).

All facts and circumstances relevant; late filed return without legitimate excuse or explanation suggests a lack of reasonable effort to comply with law: *Justice v. United States*, 817 F.3d 738 (11th Cir. 2016); *In re Payne*, 431 F.3d 1055 (7th Cir. 2005); *In re Maroney*, 352 F.3d 902 (4th Cir. 2003); *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000); *In re Hindenlang*, 164 F.3d 1029 (6th Cir. 1999).

As to the "one-day-late rule," i.e., whether a late filed return qualifies as a "return" at all under the Bankruptcy Code, *see In re Mallo*, 774 F.3d 1313 (10h Cir. 2014) and *In re McCoy*, 666 F.3d 924 (5th Cir. 2012) (late filed returns are not returns for purposes of discharge in bankruptcy).