American Bankruptcy Institute

Abundant Splits and Other Significant Bankruptcy Decisions

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Rochelle's Daily Wire

Table of Contents

Supreme Court

Last Term

Congress is the last resort for Puerto Rico to deal with looming debt default.

Supreme Court Invalidates Puerto Rico's Local Law for Municipal Debt Adjustment

The Supreme Court ruled by a vote of 5-2 that Congress both excluded Puerto Rico from chapter 9 municipal bankruptcy and precluded the island commonwealth from adopting local laws to deal with the insolvencies of its instrumentalities, such as municipal power and water companies.

The two dissenters said that "preemption here means that a government is left powerless and with no legal process to help its 3.5 million citizens." They concluded their dissent by saying, "Statutes should not easily be read as removing the power of a government to protect its citizens."

What the Opinion Means

In practical terms, Justice Clarence Thomas' June 13 majority opinion means that legislation by Congress is the last and only hope for Puerto Rico to avert a debt crisis. It is questionable whether Puerto Rico could even use some form of an equity receivership to keep the lights on and the water flowing.

To the dissenters' argument that Puerto Rico and its people "should not have to wait for possible congressional action," Justice Thomas said that "our constitutional structure does not permit this Court to 'rewrite the statute that Congress has enacted.'"

Two weeks in a row, the Supreme Court has handed down opinions allowing Puerto Rico's government to exercise less power than the states. Last week, the high court ruled in *Commonwealth of Puerto Rico v. Sanchez Valle* that the island does not have sovereign power like the states.

In the 6-2 opinion on June 9, Justice Elena Kagan held that Congress was the source of the island's sovereign powers to enact criminal laws, unlike the states, whose sovereign powers antedate the adoption of the Constitution. Consequently, the Court last week ruled that the Double Jeopardy Clause of the federal Constitution prohibits Puerto Rico, unlike a state, from prosecuting someone who had already pleaded guilty in federal court.

How Puerto Rico Was Excluded from Bankruptcy

Puerto Rico could have authorized its municipalities to use chapter 9 until the 1984 amendments to the Bankruptcy Code. For reasons it did not explain, Congress in that year prohibited Puerto Rico's instrumentalities from filing under chapter 9 when it wrote Section 101(52) of the Code to define "States" as including Puerto Rico, except for the purpose of deciding who is eligible for chapter 9. In turn, Section 109(c), referred to as the "gateway," provides that only a "municipality" can be a debtor in chapter 9. "Municipality" is defined in Section 101(40) as an instrumentality of a "State."

The definitions and cross-references mean that Puerto Rico's municipalities are ineligible for chapter 9, and the commonwealth has not argued otherwise.

No longer having access to federal bankruptcy courts, Puerto Rico still faces Section 903(1) of the Code, which says "State law" cannot bind non-consenting creditors to a debt adjustment.

Puerto Rico's Solution

Puerto Rico's governor admitted that the island is saddled with debts that are "not payable." Ineligible for chapter 9 municipal bankruptcy, Puerto Rico adopted its Public Corporation Debt Enforcement and Recovery Act in June 2014. The statute was structured so the island's public corporations could restructure debt in a manner akin to a chapter 9 debt adjustment.

That same month, bond funds affiliated with Franklin Resources Inc. and others sued the commonwealth in federal district court in Puerto Rico. In February 2015, a district judge in San Juan held that the Recovery Act was preempted by Section 903(1) of the Bankruptcy Code and therefore violated the Supremacy Clause of the U.S. Constitution on its face.

In what amounted to a 2-1 opinion in July 2015, the First Circuit held that the preemption of Puerto Rico's law was evident from the "plain meaning" of the Bankruptcy Code.

The Supreme Court granted *certiorari* at Puerto Rico's request, even though there was no split of circuits. The case was argued on March 22.

Justice Thomas' Majority Opinion

Puerto Rico presented the case to the Supreme Court as a question of statutory interpretation. The commonwealth did not contend there were residual sovereign or constitutional powers justifying the adoption of the Recovery Act. Consequently, the majority opinion does not address any theories other than statutory interpretation, while the dissenters only hint that the result could or should have been different under some notion of Puerto Rico's sovereignty or the equal protection rights of the island's residents.

Puerto Rico contended that the preemption contained in Section 903(1) does not apply to the commonwealth because nothing in chapter 9 is applicable to its municipalities given the definition in Section 101(52).

Justice Thomas rejected the argument in view of what he called the "plain text" of the statute. Although the 1984 amendment made Puerto Rico's instrumentalities ineligible for chapter 9, he held for the Court that the island "is still a 'State' for the purposes of the preemption provision" in Section 903(1). He said the dissenters' interpretation of the statute was "capacious."

The very first paragraph in Justice Thomas' opinion might be read as slamming the door on any notion that a state not electing chapter 9 eligibility retains some sovereign power to deal with the insolvencies of its instrumentalities. He said that the Bankruptcy Code "pre-empts state bankruptcy laws that enable insolvent municipalities to restructure their debts over the objections of creditors."

That statement may or may not mean that a state cannot impose a moratorium on debt payment. The majority opinion does not explicitly say that a state cannot enact a law compromising the payment of the state's own debt, as opposed to the debt of its municipalities.

Justice Samuel Alito recused himself, leaving seven justices to decide the case.

The Dissenters

Justice Sonia Sotomayor dissented in an opinion joined by Justice Ruth Bader Ginsburg. Because Puerto Rico's instrumentalities are ineligible for chapter 9, they believe that "nothing in the operation of a Chapter 9 case affects Puerto Rico's control over its municipalities." They went further to say that the definition carving out the island "excluded Puerto Rico from Chapter 9 for all purposes — it shut the gate and barred it tight."

By issuing the opinion now, rather than waiting until the Court's term ends at the end of June, the justices are placing the onus on Congress to pass pending legislation to help Puerto Rico restructure its debt under federal oversight.

The opinion is *Commonwealth of Puerto Rico v. Franklin California Tax-Free Trust*, 195 L. Ed. 2d 298, 84 U.S.L.W. 4393 (Sup. Ct. June 13, 2016).

Supreme Court reverses Fifth Circuit on 'actual fraud' dischargeability case.

Supreme Court: Misrepresentation Not Required for 'Actual Fraud' Nondischargeability

Reversing the Fifth Circuit, the Supreme Court held in *Husky International Electronics Inc. v. Ritz* that a debt can be nondischargeable for "actual fraud" under Section 523(a)(2)(A) of the Bankruptcy Code in the absence of a fraudulent misrepresentation to the creditor.

Writing the majority opinion on May 16, Justice Sonia Sotomayor held that "actual fraud" subsumes "forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation." A "fraudulent conveyance of property made to evade payments to creditors" is among the types of actual fraud that can result in a nondischargeable debt, she said.

Dissenting in the 7-1 decision, Justice Clarence Thomas argued that the majority's opinion ignores the plain meaning of the statute. Citing the *Norton* and *Collier* treatises that agree with his interpretation, he said that the "context" of the subsection "dictates that 'actual fraud' ordinarily does not include fraudulent transfers."

The majority's decision means that the debt owing to a creditor who suffers an identical injury will be discharged if that creditor does not mount an objection or holds a debt so small that objecting to dischargeability would be foolish.

The Facts of the Case

A man caused his company to transfer funds to other companies that he owned or controlled. The man later went bankrupt. Husky, owed $164,000 by the company, sued the man in bankruptcy court to hold him liable for the corporate debt and to bar discharge of the debt under Section 523(a)(2)(A).

The bankruptcy judge found that property transferred from the company to the bankrupt was a constructive fraudulent transfer because it was made without adequate consideration. Nonetheless, the bankruptcy judge rejected the request to bar discharge of the $164,000 debt to Husky. Reversing the bankruptcy court in part, the district court held that Husky was entitled to pierce the corporate veil and make the man personally liable for the debt. Nevertheless, the district court agreed with the bankruptcy court by ruling that the debt was dischargeable because the man made no misrepresentation to Husky. In a May 2015 opinion penned by Circuit Judge Carolyn King, the Fifth Circuit upheld discharge of the debt because there was no misrepresentation to Husky.

Harkening back to the *Prosser* hornbook definition of "actual fraud," the Fifth Circuit held that denial of discharge of a debt under the subsection requires misrepresentation made by the bankrupt to the creditor and reliance by the creditor. Judge King's opinion said there was no authority for the proposition that actual fraud encompasses constructive fraudulent transfers.

Underpinning the Fifth Circuit's holding was the fact that the bankrupt made no misrepresentations to the creditor.

Judge King spent the better part of her opinion explaining why a 2000 decision by Circuit Judge Richard A. Posner in *McClellan v. Cantrell* was wrong. In that case, Judge Posner held that a fraudulent misrepresentation was not the only form of fraud that renders a debt nondischargeable under subsection (a)(2)(A).

In July 2015, the First Circuit decided a similar case and agreed with Judge Posner's conclusion. To resolve a 2-1 split, the Supreme Court granted *certiorari* and heard argument on March 1.

The Statute

Section 523(a)(2)(A) prohibits discharge of debts "obtained by ... false pretenses, a false representation or actual fraud."

The former Bankruptcy Act barred discharge of a debt obtained by "false pretenses or false representation." When it adopted the Bankruptcy Code in 1978, Congress added "actual fraud." Justice Sotomayor said it was "therefore sensible" to interpret the new language as not meaning "the same thing as 'a false representation.'"

The Majority Opinion

The majority opinion says it is "equally important" under common law that "fraudulent conveyances, though a 'fraud,' do not require a misrepresentation from a debtor to a creditor." As an example, Justice Sotomayor pointed to a transfer to a relative, where the fraud occurs due to "concealment and hindrance," not from "inducing a creditor to extend a debt."

Summing up the first part of the opinion, Justice Sotomayor said that "false representation has never been a required element of 'actual fraud,' and we decline to adopt it today."

Justice Sotomayor next dealt with the debtor's argument that not requiring a misrepresentation would create overlap with subsections (a)(4) and (a)(6), which except debts from discharge for fraud or defalcation while acting in a fiduciary capacity and for willful and malicious injury to property. She admitted there is overlap, but said that "overlap is inevitable."

She saw "no reason to craft an artificial definition of 'actual fraud' merely to avoid narrow redundancies in Section 523 that appear unavoidable."

The debtor also argued that a broader interpretation of (a)(2)(A) overlaps with Section 727(a)(2), which can result in denial of discharge of all debts if the debtor committed a fraudulent transfer with actual intent to hinder, delay or defraud within one year of bankruptcy.

Although the two sections "cover some of the same conduct, they are meaningfully different," Justice Sotomayor said. A Section 727 violation is broader by preventing discharge of all debt, but is narrower than subsection (a)(2)(A) regarding timing.

The Dissent

Dissenting, Justice Thomas said that subsection (a)(2)(A) only covers situations where money or property was "obtained by" actual fraud. He said that a violation occurs "only when the fraudulent conduct occurs *at the inception of the debt.*" [Italics in original.] In the case on *certiorari*, the debtor's fraudulent transfers to his companies "did not trick the creditor into selling his goods."

The Application of *Husky* in Practice

Husky entailed fraudulent transfers for lack of adequate consideration that contributed to making the company unable to pay its debts. Even though the transfers were technically made by the debtor's company, the debtor himself would have been denied a discharge of all his debt under established principles had he orchestrated the company's fraudulent transfers within one year of his own bankruptcy with actual intent to hinder or delay the company's creditors.

As a result of *Husky*, an individual who orchestrates his company's fraudulent transfer more than a year before bankruptcy will forfeit dischargeability of debt owing to a particular creditor, so long as that creditor mounts an objection.

A similarly situated creditor who does not bother to object will see that debt discharged, despite suffering an identical injury.

To promote equality of treatment of creditors, will trustees now initiate proceedings on behalf of all similarly situated creditors to preclude the discharge of those debts? Or can one creditor mount a dischargeability objection on behalf of a class of similarly situated creditors?

In either instance, the result, if successful, would be equivalent to a denial of discharge even though the infringing fraudulent transfer occurred more than one year before bankruptcy.

Were he still alive, Justice Antonin Scalia might have agreed with Justice Thomas and lent a strong voice in favor of upholding the Fifth Circuit. As it is, the lower courts must now struggle with the task of crafting rules so that dischargeability objections do not morph into denials of discharge. They must also confront the task of ensuring that debts owing to deep-pocket creditors are not the only ones discharged when a debtor's conduct could result in the denial of discharge of debts owing to many creditors.

Arguably, the *Husky* opinion finds the Supreme Court making what the majority see as a logical extension of the statute. Justice Scalia might have attacked *Husky* as judicial legislating. In any event, creditors now have a new weapon to use against debtors, and bankruptcy courts must begin crafting new rules to deal with problems created by *Husky*.

The opinion is *Husky International Electronics Inc. v. Ritz*, 136 S. Ct. 1581, 194 L. Ed. 2d 655 (Sup. Ct. May 16, 2016).

Showing violation of a federal statute might not itself entitle a consumer to sue.

Supreme Court Temporarily Ducks Case on Individuals' Right to Sue

By remanding, the Supreme Court for the time being avoided deciding a case that could preclude bankrupts and consumers generally from suing companies that violate their statutory rights absent proof of "concrete" injury. For example, individual debtors might be disabled from suing for a willful violation of the automatic stay under Section 362(k) without proving "concrete" injury, depending on how the justices eventually rule on the issue.

The high court granted *certiorari* in *Spokeo Inc. v. Robbins*, ostensibly to decide whether Congress can confer standing to sue in federal court based on a bare violation of a federal statute when the plaintiff suffers no concrete harm. Perhaps because the justices would have been split 4-4 on the outcome had they reached the merits, the Court remanded the case for the Ninth Circuit to analyze whether the plaintiff satisfied the "concreteness" aspect of the standing requirements.

The Facts

An individual filed a class suit under the federal Fair Credit Reporting Act of 1970. The statute requires credit reporting agencies to "follow reasonable procedures to assure maximum possible accuracy." For any willful violation, a plaintiff is entitled to actual damages or statutory damages of $100 to $1,000 per violation. In addition, the plaintiff can recover costs, attorneys' fees, and possibly punitive damages.

The defendant, Spokeo Inc., a search engine that aggregates data about individuals, reported that the plaintiff was wealthy, employed and married with children, and had an advanced degree. In fact, the plaintiff was unemployed, unmarried and without children. The plaintiff contended in his complaint that he was injured because the report made him appear overqualified for the jobs he was seeking and implied that he might be unwilling to move given family ties.

The district court dismissed the complaint for lack of standing, but the Ninth Circuit reversed.

Certiorari Granted Without a Circuit Split

The Supreme Court granted *certiorari*, although no circuit court had held to the contrary, according to the plaintiff and *amici* filing briefs in his support. The Supreme Court's decision to hear the case led to speculation that a majority were bent on further restricting the ability of consumers to mount lawsuits for the recovery of damages for violations created by acts of Congress, when there would have been no cause of action under common law.

The case was argued in November, before the death of Justice Antonin Scalia in February.

The Majority Opinion

Without reaching the merits, the Supreme Court remanded the case to the circuit court by a 6-2 decision handed down on May 16, in the process giving no hint of how a majority of justices would rule on the ultimate question.

The majority opinion, written by Justice Samuel A. Alito Jr., was joined by Justices Anthony M. Kennedy, Clarence Thomas, Stephen G. Breyer, Elena Kagan, and Chief Justice John G. Roberts Jr. Justice Thomas filed a concurring opinion. Justice Ruth Bader Ginsburg dissented in an opinion that was joined by Justice Sonia Sotomayor.

Justice Alito's opinion purports to lay out the Court's traditional jurisprudence on the constitutional aspects of standing, ostensibly to aid the Ninth Circuit on remand. Standing, he said, is rooted in the constitutional requirement for the existence of a case or controversy. Among the three constitutional requirements, there must be "injury in fact." Congress, according to Justice Alito, cannot create standing by statute when none would exist in a constitutional sense.

To establish "injury in fact," the plaintiff must show invasion of a legally protected right that is "concrete and particularized." To be "particularized," it "must affect the plaintiff in a personal and individual way." Particularization is necessary but not enough in itself. The injury, he said, must also be "concrete." To be "concrete," the injury "must actually exist." Nonetheless, "intangible injuries can nevertheless be concrete," Judge Alito said.

Although "Congress is well positioned to identify intangible harms," Justice Alito said that injury-in-fact is not automatically satisfied "whenever a statute grants a person a statutory right and purports to authorize that person to sue." Significantly, he said that constitutional "standing requires a concrete injury even in the context of a statutory violation."

Faulting the circuit court for not analyzing the "concreteness" requirement, Justice Alito remanded the case. The plaintiff, he said, cannot show "concreteness" by proving a "bare procedural violation," such as an incorrect zip code. "It is difficult to imagine how the dissemination of an incorrect zip code, without more, could work any concrete harm," he said.

The Dissenters

Justice Ginsburg wrote a dissenting opinion, joined by Justice Sotomayor. Although Justice Ginsburg agreed "with much of the Court's opinion," she disagreed about the need for remand.

The plaintiff's allegations "carry him across the threshold" of "concreteness," Justice Ginsburg said, because the Court's "particularity" precedents bar "complaints raising generalized grievances, seeking relief that no more benefits the plaintiff than it does the public at large."

For Justice Ginsburg, the plaintiff's complaint was adequate because he did not "seek redress for harm to the citizenry, but for Spokeo's spread of misinformation specifically about him."

After Remand

Although it is clear that Justices Ginsburg and Sotomayor believe there is standing, nothing in Justice Alito's majority opinion reveals how he and the other five justices see the outcome, nor does it imply that the Ninth Circuit misunderstood the law. Consequently, the circuit court is likely to stand by its prior reversal and uphold the plaintiff's standing to sue, giving rise to another petition for *certiorari*.

There is no assurance that the high court will grant *certiorari* a second time. Before Justice Scalia's death, there may have been a majority to reverse the Ninth Circuit and find no standing. The outcome now may depend on the inclinations of whoever replaces Justice Scalia.

If it becomes clear that the new member of the court would form a majority to hold that the plaintiff had constitutional standing, the court might not grant *certiorari* a second time in the continuing absence of a circuit split. Still, the vote of only four justices is required to grant *certiorari*, leaving open the possibility of another argument and a decision on the merits next year in the Supreme Court. In sum, a ruling in 2017 could be the opposite of what it might have been were Justice Scalia still alive, if the new member of the Court does not have Justice Scalia's inclinations.

Implications for Bankruptcy

An ultimate victory for Spokeo could end many lawsuits by consumers and claims by bankrupts for violations of the automatic stay. For example, some judges do not tolerate the slightest transgression of the automatic bankruptcy stay before finding a violation of the Fair Debt Collection Practices Act, or FDCPA.

The question of whether the Bankruptcy Code is the exclusive remedy for many debtors suing under the FDCPA is now on appeal in several circuits. Even assuming FDCPA suits by bankrupts are allowed to stand, a lack of standing could bar a debtor from suing a creditor under the FDCPA for filing a time-barred claim, absent a showing of concrete damages.

When it comes to filing claims barred by the statute of limitations, other creditors or a trustee might have standing, but not a debtor who enjoys a discharge of the debt in any event.

Likewise, a debtor might be unable to claim damages for violation of the automatic stay without proof of injury.

The opinion is *Spokeo Inc. v. Robins*, 136 S. Ct. 1540, 194 L. Ed. 2d 635 (Sup. Ct. May 16, 2016).

Next Term

ROCHELLE'S DAILY WIRE

Having avoided chapter 11 cases, the high court will tackle a major reorganization issue.

Supreme Court Will Review *Jevic* to Rule on Structured Dismissals and Gift Plans

The Supreme Court granted *certiorari* in *Czyzewski v. Jevic Holding Corp.* to decide whether bankruptcy courts are allowed to dismiss chapter 11 cases when property is distributed in a settlement that violates the priorities contained in Section 507 of the Bankruptcy Code.

Although *Jevic* deals with structured dismissals, the high court's decision might also have the effect of allowing or barring so-called gift plans where a secured creditor or buyer makes a payment, supposedly from its own property, that enables a distribution in a chapter 11 plan not in accord with priorities.

Granting *certiorari* was not surprising because there has been a long-standing split of circuits. In *Jevic*, the Third Circuit approved a structured dismissal in May 2015 following the Second Circuit, which had ratified structured dismissals in its 2007 *Iridium* decision.

Conversely, the Fifth Circuit barred structured dismissals in 1984 when it decided *Aweco* and held that the "fair and equitable" test must apply to settlements.

Before acting on the *certiorari* petition, the Supreme Court sought comment from the Solicitor General. In May, the federal government's counsel in the Supreme Court recommended granting review and reversing the Third Circuit.

The *Jevic* petition was on the justices' calendar for review at a conference on June 23. In line with the Court's practice of reviewing petitions at two conferences before granting *certiorari*, the case was reviewed once again at a conference on June 27. The Supreme Court granted the petition on June 28.

Structured dismissals occur when the sale of a company's assets in chapter 11 will not generate enough cash to pay priority claims in full and permit confirmation of a plan. In the unsuccessful reorganization of Jevic Holding Corp., the official unsecured creditors' committee had sued the secured lender and negotiated a settlement calling for the lender to set aside some money for distribution to unsecured creditors following dismissal. The distribution scheme did not follow priorities in Section 507 because wage priority claimants received nothing from the lender through a trust set aside exclusively for lower-ranked general unsecured creditors.

Over the wage claimant's objection, the bankruptcy court's approval of the settlement was upheld in the district court and the Third Circuit. The appeals court's opinion was important because the Third Circuit makes law for Delaware, where many of the country's largest chapter 11s are filed.

The Third Circuit's opinion was 2-1, with the dissenter saying that while structured dismissals are permissible, *Jevic* was not a proper case.

Recommending that the Supreme Court review and reverse the Third Circuit, the Solicitor General said that "bankruptcy is not a free-for-all in which parties or bankruptcy courts may dispose of claims and distribute assets as they see fit." He argued that "nothing in the Code authorizes a court to approve a disposition that is essentially a substitute for a plan but does not comply with the priority scheme set forth in Section 507."

There are powerful arguments in support of the Third Circuit's opinion. To begin with, there is nothing in the Bankruptcy Code explicitly saying that priorities govern settlements under Bankruptcy Rule 9019. Proponents of structured dismissals also rely on the notion that the distribution is the lender's own property, not property of the estate, thus making priorities inapplicable.

The position of the Solicitor General came as no surprise because the government lost a similar case called *In re LCI Holding Co.*, in which the Third Circuit sanctioned so-called gift plans that distribute estate property counter to bankruptcy priorities. The *LCI* and *Jevic* cases were argued the same day in January 2015, but before different panels of the Third Circuit. Although it was the primary objector in *LCI*, the government did not pursue a *certiorari* petition.

While the schedule for *Jevic* was not immediately announced, argument in the Supreme Court might take place in December, with an opinion to be issued in the first quarter of 2017.

The *Jevic* case in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649. The opinion in the Third Circuit is *Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3d Cir. May 21, 2015).

High court grants* certiorari *in a second bankruptcy case for the new term.

Supreme Court to Resolve Circuit Splits on the Fair Debt Collection Practices Act

The Supreme Court will decide this term whether the Bankruptcy Code impliedly repealed the federal Fair Debt Collection Practices Act, or FDCPA, and whether the filing of a knowingly time-barred proof of claim violates the FDCPA.

In *Midland Funding LLC v. Johnson*, the Supreme Court granted *certiorari* on Oct. 11 to resolve a split among the circuits. In *Johnson*, the Eleventh Circuit held in May that the later-adopted Bankruptcy Code did not impliedly repeal the FDCPA. The decision was no surprise because the Eleventh Circuit had held in 2014 in *Crawford v. LVNV Funding LLC* that filing a stale claim barred by a statute of limitations violates the FDCPA. In *Crawford*, the appeals court had not reached the issue of implied repeal.

The issues are "exceptionally important," Daniel Geyser told ABI in an e-mailed message, because these "questions have hopelessly divided the courts." Geyser, of Los Angeles, represents the debtor in *Johnson*.

Splits in the Circuits

In *Nelson v. Midland Credit Management Inc.*, the Eighth Circuit differed from the Eleventh when it held in July that filing a stale proof of claim does not violate the FDCPA.

In August, the Fourth Circuit likewise held in a 2-1 opinion that filing a time-barred claim does not violate the FDCPA, because the Bankruptcy Code and Rules invite creditors to file proofs of claim based on stale debts.

The Seventh, Eighth and Second Circuits have already held that the FDCPA is not violated when a creditor files a claim based on a debt where collection is precluded by the statute of limitations. The decision by the Seventh Circuit in August encountered a vigorous dissent from Chief Judge Diane P. Wood.

The circuit courts were already split on whether the Bankruptcy Code impliedly repealed the FDCPA. The Second and Ninth Circuits saw implied repeal. The Third, Seventh and Eleventh Circuits held there is no implied repeal because the FDCPA and the Bankruptcy Code may coexist since creditors can comply with both simultaneously.

Courts finding no fundamental conflict between the two statutes note that the Bankruptcy Code does not compel creditors to file proofs of claim.

The Stale Debt Collection Business

An industry came into being when debt collectors began paying small amounts to buy debts where statutes of limitations would preclude recovery were they to file suit.

Purchasers of stale claims have computer systems that alert them to file proofs of claim when their debtors file bankruptcy. The purchasers' claim forms typically disclose all required information that should alert trustees and debtors to the fact that collection of the debts would be time-barred.

The business model is based on the assumption that there will be no objection to the claims in some cases, either through inadvertence or because objecting is not economically justifiable or is not covered by counsels' flat-fee arrangements.

Since the creditors will have paid so little for the claims, the allowance of just a few will still make the business profitable.

Courts have held that filing suit on a time-barred claim violates the FDCPA because a consumer is not already represented by counsel, as would be the case in bankruptcy.

The Competing Theories

The Eleventh Circuit in particular was bent on stamping out the business. In addition to adding costs to bankruptcy cases by forcing trustees or debtors to object to patently time-barred claims, the Atlanta-based appeals court said that creditors with legitimate claims suffer from the dilution of their recoveries when trustees or debtors fail to object.

Courts finding no violation of the FDCPA take the view that the system is designed to deal with bogus claims because trustees' duties include objecting to such claims.

Requiring debt collectors to comply with both the Bankruptcy Code and FDCPA, the Eleventh Circuit rejected the notion that the Code creates a safe harbor by soliciting creditors to file claims. The Atlanta-based court said that the "Code does not at the same time protect those creditors from all liability." Consequently, the Eleventh Circuit said that a "particular subset of creditors – debt collectors – may be liable under the FDCPA for bankruptcy filings they know to be time-barred."

To read ABI's discussion of the *Johnson* decision in the circuit court, click here. To read about the Eighth Circuit's opinion in *Nelson v. Midland Credit Management Inc.*, click here. For discussion of the Seventh Circuit opinion from August, click here.

Johnson will likely be argued early next year, with a decision before the end of the Supreme Court's term in late June.

The docket for the case in the Supreme Court is *Midland Funding LLC v. Johnson*, 16-348 (Sup. Ct.).

Reorganization

Sales

ROCHELLE'S DAILY WIRE

Due process failure exposes New GM to liabilities for Old GM's conduct.

Second Circuit Drubs New GM on Successor Liability for Ignition Switch Defects

The Second Circuit handed a stinging defeat to General Motors Co. (also known as New GM) in an opinion on July 13 that countenances no excuse for failing to give actual notice to creditors of an impending sale when the company in reorganization knows the claims to exist.

It is not entirely clear from the opinion whether a purely third-party purchaser of assets "free and clear" at a bankruptcy sale will be saddled with successor liability on claims of known creditors who were not given notice of an upcoming sale. In the GM case, the auto maker essentially remained in business after the assets were sold in a Section 363 sale, thus making successor liability an easier pill to swallow.

Although the Second Circuit is allowing lawsuits against New GM based on defective ignition switches, the appeals court did not decide whether New GM in fact has successor liability.

The opinion is an important pronouncement on the due process rights of known creditors and the consequences of a lack of notice. The opinion leaves open the question of whether the lack of prejudice can turn a due process violation into harmless error.

The Second Circuit's opinion on July 13 implies that third party-purchasers are well advised to require an escrow to cover claims of creditors who were not given notice.

The GM Bankruptcy and Quick Sale

Old GM, named General Motors Corp. before bankruptcy, was in severe financial distress and likely would have liquidated absent financial assistance from the federal government before and after its chapter 11 filing in June 2009. Within 40 days of bankruptcy, the bankruptcy court in New York approved a sale of the business as a going concern to New GM, which was initially 60% owned by the government.

The sale carved out 10% of the stock and warrants that eventually ended up in the hands of unsecured creditors when Old GM later confirmed a liquidating chapter 11 plan.

In the bankruptcy court's 2009 sale approval order, New GM agreed to assume responsibility only for specified liabilities, including warranty claims, accidents occurring after the sale, and

Lemon Law claims. Otherwise, the sale was supposedly free and clear of claims, thus broadly immunizing New GM from successor liability claims.

In early 2014 – after plan confirmation in 2011 – New GM initiated recalls of millions of vehicles. It was later discovered that Old GM had known about a defect in its ignition switches for several years before bankruptcy.

The defect caused cars and their electrical systems to shut down unexpectedly, in some cases causing accidents. With the electrical system off, air bags would not inflate, resulting sometimes in death or injury.

New GM was hit with a deluge of lawsuits following disclosure of the switch defect. New GM responded with a motion asking the bankruptcy judge to enforce the "free and clear" sale order and bar claims against it based on the switch defect.

New GM also wanted the bankruptcy court to bar plaintiffs from making claims against the trust created for unsecured creditors under the confirmed plan.

Judge Gerber's Opinion

Now-retired Bankruptcy Judge Robert E. Gerber issued his ruling in April 2015. According to the 74-page opinion by Circuit Judge Denny Chin, Judge Gerber found that the "ignition switch claims were known to or reasonably ascertainable by Old GM" and were therefore entitled to actual notice as a matter of due process.

On an issue on which the circuit court disagreed, the bankruptcy judge decided that the plaintiffs suffered no prejudice from the lack of due process because he would have approved the sale in any event.

As a result, the bankruptcy court ruled that New GM could be liable only for its "own wrongful conduct" after the sale, such as failure to disclose the defect sooner. Judge Gerber did not decide whether New GM had any liability for its own conduct. That presumably would be a question for the class action courts.

Judge Gerber also ruled that equitable mootness would bar any claims against the creditors' trust. He certified the case for direct appeal to the Second Circuit.

Bankruptcy Sales and Successor Liability

Whether bankruptcy sales can cut off successor liability was the first issue for Circuit Judge Chin. He agreed with other courts holding that "successor liability claims can be 'interests'" cut off by Section 363.

Although Section 363(f) does not expressly import the definition of "claims" into the concept of "interests," successor liability qualifies as a claim, Judge Chin said.

While requirements of due process do not cover claimants who are "completely unknown or unknowable," Judge Chin held that a Section 363 sale can cut off successorship claims arising from pre-petition conduct, so long as the claimant is "identifiable."

The Second Circuit on Due Process

The bankruptcy court had held that pre-closing accident claims and claims for economic loss were barred by the sale order. The appeals court reversed that holding on due process grounds.

Judge Chin said that "if a debtor does not reveal claims that it is aware of, then bankruptcy law cannot protect it." He also said that "New GM essentially asks that we reward debtors who conceal claims against potential creditors" and observed that "the need for speed did not obviate basic constitutional principles." Those policy statements presaged the holdings to follow.

Given that ignition switch claim holders were known creditors entitled to notice, they were therefore entitled to due process protections.

Despite the failure of due process, the bankruptcy judge had decided there was no prejudice to the plaintiffs because he would have approved the sale regardless. Although he did not decide whether prejudice must be shown to prove a denial of due process, Judge Chin reversed because there was prejudice.

Judge Chin said that "we do not know what would have happened" if plaintiffs with billions in claims were opposing sale approval while negotiating with the government and Old GM. He pointed to states' attorneys general who objected to the sale and ended up with a concession where New GM assumed liability for Lemon Law claims.

Further, he said, "New GM was not a truly private corporation." Since plaintiffs could petition the government for an accommodation on account of their claims, Judge Chin said the plaintiffs also might have negotiated concessions given the cost of bankruptcy and the need to complete the sale quickly.

Given prejudice, the Second Circuit reversed "the bankruptcy court's decision insofar as it enforced the sale order to enjoin claims related to the ignition switch defect." In other words, plaintiffs are at liberty to pursue New GM on successor liability theories.

When a case arises in the future where creditors were not given notice, an innocent purchaser seeking to avoid successor liability can distinguish the GM case on the grounds that the auto maker at the time was a government-owned entity with an endlessly deep pocket. On the other hand, GM today is privately owned, suggesting that public ownership at the time of a due process violation was not the pivotal factor for the Second Circuit.

Reversal on Other Issues

Although believing the sale order even covered claims for New GM's own conduct, the bankruptcy court allowed the plaintiffs to pursue those theories. Judge Chin went a step further and interpreted the sale order as not even barring claims based on New GM's own conduct.

The bankruptcy court also barred purchasers of used cars from suing New GM. The Second Circuit reversed on that ground, too, because there was "no conduct or relationship" between Old GM and used car purchasers.

Equitable Mootness

While the creditors' trust didn't believe it had a dog in the fight, the bankruptcy court nonetheless barred the plaintiffs from pursuing claims against the trust on the grounds of equitable mootness, at New GM's behest. The Second Circuit reversed, holding that the bankruptcy court's decision in that respect was an advisory opinion.

Judge Chin said that there must be an Article III case or controversy "before relief may be equitably moot." In a footnote, he said that the court was not deciding whether the bankruptcy court – as opposed to an appellate court – can invoke equitable mootness.

Since none of the plaintiffs had taken even the first step to collect from the creditors' trust, the circuit court held that the bankruptcy court had improperly issued an advisory opinion because there was no case or controversy. The opinion, therefore, does not say one way or the other whether equitable mootness protects the trust's assets.

The opinion is *Elliott v. General Motors LLC (In re Motors Liquidation Co.)*, 15-2844 (2d Cir. July 13, 2016).

Common ownership and management aren't enough to prove 'single employer' liability.

Third Circuit Precludes WARN Act Liability for Acquirers in Typical LBOs

While one issue in the bankruptcy of Jevic Holding Corp. will be decided next year in the Supreme Court, the Third Circuit used the Jevic bankruptcy to slam the door on the notion that the acquirer in a typical leveraged buyout takes on liability for workers' wages under the federal Worker Adjustment and Retraining Notification Act, or WARN Act.

Sun Capital Partners Inc., a private-equity investor, acquired Jevic in 2006. Two years later, Jevic was liquidating in bankruptcy, firing workers in the process. Workers mounted a class suit in bankruptcy court against Sun Capital, contending they were not given the 60 days' notice of mass layoffs required by the WARN Act.

Bankruptcy Judge Brendan Shannon of Delaware granted summary judgment in favor of Sun Capital and was upheld in September 2014 by District Judge Sue L. Robinson. The workers fared no better when the Third Circuit upheld the lower courts' "well-reasoned opinions" on July 27.

The appeals court's non-precedential decision by Circuit Judge Anthony J. Scirica said there was no liability under the "single employer" doctrine because the plaintiffs failed to bring facts forward satisfying the applicable five-part test.

Although Sun Capital conceded there was common ownership and common directors and officers, Judge Scirica said the plaintiffs did not satisfy the third test, requiring *de facto* control, because Jevic itself decided to shut down.

Similarly, the plaintiffs failed to show "unity of personnel policies" and "dependency of operations."

Even when the first two parts of the test are satisfied, Judge Scirica said that *Jevic* is another case where there is no single-employer liability absent proof satisfying the final three factors.

The Supreme Court granted *certiorari* in *Czyzewski v. Jevic Holding Corp.* to decide whether bankruptcy courts are allowed to dismiss chapter 11 cases when property is distributed in a settlement that violates the priorities contained in Section 507 of the Bankruptcy Code. To read ABI's discussion on that issue, click here.

The WARN opinion is *Czyzewski v. Jevic Transportation Inc. (In re Jevic Holding Corp.)*, 14-4331 (3d Cir. July 27, 2016). The *Jevic* case in the Supreme Court is *Czyzewski v. Jevic Holding Corp.*, 15-649.

Jurisdiction & Power

ROCHELLE'S DAILY WIRE

Enforcing an Article III court's decision on ownership is a 'core' proceeding, Judge Posner rules.

Bankruptcy Court Has 'Core' Power to Enforce a Final 'Non-Core' Order, Circuit Says

Not pausing to cite authority other than the statute and rules, Seventh Circuit Judge Richard A. Posner laid down a significant, albeit obvious, rule on the final adjudicatory power of bankruptcy courts.

Creditors filed an adversary proceeding alleging that third parties' assets actually belonged to the bankrupt estate. The bankruptcy judge issued proposed findings and conclusions recommending that the district court enter judgment for the plaintiffs. The district court entered judgment and remanded the case for the bankruptcy court to order turnover of the assets.

Although the third parties did not appeal the bankruptcy court's turnover order, they appealed to the circuit court from the district court order remanding to the bankruptcy court. The third-party defendants argued that only the district court could enter a final turnover order in view of 28 U.S.C. Section 157(c)(1).

Reciting the differences between core and non-core proceedings, Judge Posner said in his Aug. 11 opinion that the limitations on the power of a bankruptcy court under subsection (c)(1) "are irrelevant" because they only apply to non-core matters. Although the adversary proceeding was non-core in declaring that the property belonged to the estate, Judge Posner held that the turnover order was a core proceeding, allowing the bankruptcy judge to enter final judgment.

In other words, a bankruptcy court has final adjudicatory power to order turnover of property when an Article III court has already ruled on ownership. Presumably also, in view of last year's *Wellness International Network Ltd. v. Sharif* decision from the Supreme Court, the bankruptcy court can enter a final turnover order if the parties impliedly or actually consented to final adjudication in bankruptcy court on the underlying ownership question.

The opinion is *BLC-Sheffield LLC v. Gemini International Inc. (In re Tolomeo)*, 16-1083 (7th Cir. Aug. 11, 2016).

Findings of fact determine whether bankruptcy court can enter a final order.

'Summary Jurisdiction' Resurrected to Permit Final Order on Property Ownership

A decision by a district judge in Detroit prompts the reader to question the continuing validity of a series of opinions by the Supreme Court in the first half of the 20th century holding that a bankruptcy judge has constitutional authority to enter final judgment directing turnover of property when the defendant third party has a merely colorable claim to ownership.

The opinion means that a bankruptcy court can create final adjudicatory power for itself by making requisite findings of fact without having them reviewed *de novo* by a district judge.

District Judge Matthew F. Leitman based his decision on the concept of summary jurisdiction under the former Bankruptcy Act and, in large part, on the dissenting opinion by Chief Justice John G. Roberts Jr. in *Wellness International Network Ltd. v. Sharif* on an issue where a majority of the Supreme Court were silent.

The Facts

Years before a man filed a chapter 7 petition, he had set up a not-for-profit corporation to acquire historically important documents. Initially, the trustee filed an adversary proceeding alleging that the corporation received fraudulent transfers from the debtor. After discovery, the trustee changed course and filed a turnover motion under Section 542(a) alleging that the corporation was in possession of property belonging to the debtor.

After a trial with witnesses, the bankruptcy judge entered a final turnover order concluding, among other things, that the debtor owned the disputed property because he had "comprehensively comingled his financial affairs with those" of the corporation.

Contending that the bankruptcy judge had no jurisdiction to enter a turnover order, the corporation appealed, only to lose in Judge Leitman's Oct. 6 opinion.

The Resurrection of Summary Jurisdiction

Judge Leitman said that the "parameters of bankruptcy court jurisdiction" under the Act are "especially helpful" in discerning the limits of "modern bankruptcy court jurisdiction." He focused on the distinction between summary and plenary jurisdiction under the Act.

Before adoption of the Bankruptcy Code in 1978, bankruptcy courts, according to Judge Leitman, had summary jurisdiction to enter a final order, without consent, resolving title to property when the debtor or the trustee had possession. Similarly, there was summary jurisdiction, he said, when the debtor had constructive possession.

Significantly, Judge Lietman said there would be constructive possession under *Taubel-Scott-Kitzmiller Co. v. Fox*, where the Supreme Court found constructive possession in 1924 when the third party's claim to ownership was "colorable only." Conversely, there was no constructive possession when the third party raised a "substantial claim" to ownership.

Sampsell v. Imperial Paper & Color Corp. was also important, Judge Leitman said, because the Supreme Court held in 1941 that "a mere *alter ego*" cannot make a substantial adverse claim. In other words, finding someone to be an *alter ego* would convert a plenary proceeding into a summary proceeding.

Consequently, Judge Leitman concluded that the bankruptcy court would have had summary jurisdiction under the Act to enter a final turnover order because the corporation's claim was "entirely baseless and, thus, merely 'colorable.'"

Applying Code Concepts

Under the Code, Judge Leitman held that the turnover motion was "core" because the corporation's claim to ownership was "entirely baseless."

Even though the dispute was "core," he then examined whether the bankruptcy court had final adjudicatory power under *Stern v. Marshall*. At that juncture, he relied in large part on the Chief Justice's dissent in 2015 in *Wellness International*, where a bare majority of the Court held that actual or implied consent enables a bankruptcy judge to make final decisions on matters that otherwise would only be within the purview of a federal district judge.

While dissenting on the consent issues, the Chief Justice made a pronouncement that, if adopted by the entire court, would expand the powers of bankruptcy judges in one respect. He said a bankruptcy court has the power to make a final decision on disputed ownership of property as long as there are no adverse claims by third parties. The majority expressed "no view" on that issue.

Judge Leitman cited the Chief Justice's dissent as confirmation that the final turnover order did not offend the Constitution because it "was fully consistent with the historical exercise of core bankruptcy jurisdiction."

In particular, Judge Leitman quoted from the Chief Justice's dissent where he distinguished an *alter ego* claim from a fraudulent transfer claim. In that respect, the Chief Justice said that a fraudulent transfer claim "seeks assets in the hands of a third party, while an *alter ego* claim targets only the debtor's 'second self.'"

The Supreme Court "came with something that is workable under the 1898 Act and it's not clear why we should be trying to reinvent the wheel," Prof. Ralph Brubaker told ABI in an interview. In his opinion, Judge Leitman copiously quoted scholarly writings by Prof. Brubaker, who is the Carl L. Vacketta Professor of Law at the University of Illinois College of Law.

Interpreting the Opinion

Judge Leitman's opinion could be read to mean that a bankruptcy court has final adjudicatory power in piercing the corporate veil or holding someone to be the debtor's *alter ego*. In other words, a bankruptcy court's findings of fact, although not reviewed *de novo*, create constitutional power to enter a final order, at least when there is no substantial evidence to justify the third party's claim to ownership.

Arguably, *denial* of *alter ego* or corporate veil arguments would not be final under Judge Leitman's analysis, assuming that the presence of substantial facts implicates Article III powers.

If the third party's claim to ownership is more than colorable, it is unclear whether Judge Leitman would find final power to enter a turnover order. By citing the Chief Justice's *Wellness International* dissent, however, Judge Leitman's opinion might be read to imply that any *alter ego* claim gives rise to a final order, even if there is substantial evidence of adverse ownership.

Judge Leitman also held that the corporation had no right to a jury trial. Procedurally, he said that an adversary proceeding was not required, and if it was, the corporation suffered no prejudice.

Revisiting Prior Supreme Court Holdings

It is not entirely clear that *Taubel-Scott-Kitzmiller* and *Sampsell* remain good law in the wake of *Stern v. Marshall* and its progeny. In the 21st and late 20th centuries, the Supreme Court has been more protective of the prerogatives of Article III judges and less prone to allowing bankruptcy judges to exercise the full panoply of judicial powers. Still, there is no indication from *Northern Pipeline* and later cases that the Supreme Court is inclined to repudiate opinions from 100 years ago placing limits on the powers of bankruptcy referees, even though those decisions were not couched in constitutional terms.

Judge Leitman's opinion would be an ideal vehicle for testing whether venerable Supreme Court authorities from the early 20th century were impliedly overruled by a more restrictive notion of constitutional limitations on the powers of bankruptcy courts. The chances of an appeal are remote because Judge Leitman said he would reach the same result under *de novo* review if the issue were non-core.

Judge Leitman is a graduate of Harvard Law School and was appointed to the district court in 2016.

The opinion is *Reed v. Nathan*, 15-14462 (E.D. Mich. Oct. 6, 2016).

Bankruptcy failed to insulate the Wyly brothers from an SEC asset freeze.

SEC Can Freeze Assets Without Violating the Automatic Stay, Circuit Holds

Someone accused of securities fraud cannot file bankruptcy to bar the Securities and Exchange Commission from freezing assets in district court, according to the Second Circuit.

Sam Wyly, his deceased brother Charles and their alleged violations of securities laws gave the appeals court occasion on Dec. 18 to draw the contours more clearly delineating the demarcation between the automatic stay and the exception in Section 362(b)(4) allowing governmental enforcement of police and regulatory powers. After a six-week trial in federal district court in Manhattan, a jury decided in May 2014 that the brothers violated securities laws by using offshore trusts to trade secretly in the stock of companies for which they served on their boards.

Without a jury, District Judge Shira Scheindlin in New York concluded in September 2014 that some $300 million was a reasonable approximation of disgorgement of the brothers' ill-gotten gains, measured by the taxes they improperly evaded. The SEC then moved to freeze their assets. While the motion was pending, Sam filed a chapter 11 petition in Dallas in October 2014. Four days later, Caroline Wyly, the widow of Charles, filed a companion chapter 11 petition.

Judge Scheindlin froze Wyly family assets in an opinion in November 2014 in which she concluded that the automatic stay did not apply. While allowing everyone living expenses, she also froze assets of 16 other family members.

On the automatic stay issue, the family appealed and lost in an opinion by Circuit Judge Jose A. Cabranes. Sam did not appeal the decision, nor did Caroline, who had initiated proceedings in Dallas, where the bankruptcy judge ruled that the automatic stay does not preclude an asset freeze.

Judge Cabranes' opinion focused on the Second Circuit's 2000 decision in *SEC v. Brennan*, in which the appeals court found a violation of the automatic stay because the district court had ordered the repatriation of assets following entry of judgment. In that case, the appeals court believed that repatriation was preparatory to collection of a judgment and thus violated the stay.

The Wyly case was different, Judge Cabranes said, because the asset freeze only preserved the status quo and did not "rise to the level of impermissible *enforcement* of a money judgment." On statutory and policy grounds, he found that the "pre-judgment asset freeze at issue here thus does not implicate the same concerns as did the post-judgment repatriation and deposit order in *Brennan*."

The result turned in significant part on the contours that Judge Scheindlin gave to the asset freeze. In particular, the freeze will dissolve once the assets are under the bankruptcy court's control. At that point, Judge Cabranes said in a footnote, the "bankruptcy court will continue its work without the involvement of the district court."

The decision was not a total victory for the SEC. With respect to seven family members, the appeals court reversed and remanded, directing Judge Scheindlin to decide whether there was evidence that they had received ill-gotten gains.

The opinion dealt only with the automatic stay and not with the amount of the asset freeze or whether the Wylys violated securities laws.

The opinion is *Miller v. SEC*, 808 F.3d 623 (2d Cir. Dec. 18, 2015).

Eleventh Circuit allows the government on its own to shut down a health care provider in chapter 11.

Circuits Now Split on Bankruptcy Jurisdiction over Medicare Disputes

Creating a circuit split, the Eleventh Circuit held that bankruptcy courts lack jurisdiction under 11 U.S.C. Section 1334 to compel the federal government to continue Medicare and Medicaid funding.

In practical effect, the appeals court's decision on July 11 enables the government singlehandedly to shut down a health care facility that attempts to reorganize in chapter 11. The Ninth Circuit reached the opposite conclusion in 1991, and the lower courts are split.

The Bankruptcy Court Overrules Medicare/Medicaid

After an inspection, the Department of Health and Human Services notified a nursing home that it was terminating its Medicare and Medicaid provider agreement because conditions in the facility were endangering patient health. When a district judge ruled there was no jurisdiction to enjoin termination of the agreement, the facility immediately filed a chapter 11 petition in Tampa, Fla.

Concluding that he had jurisdiction, Bankruptcy Judge Michael G. Williamson enjoined the government from cutting off funding under Section 1334, the provision in the federal Judiciary Code creating bankruptcy jurisdiction. Later, the bankruptcy court confirmed the nursing home's chapter 11 plan and approved assumption of the provider agreement over the government's objection, again barring the government from shutting off funding.

Government Wins the First Appeal

Although courts are divided on the issue, District Judge James S. Moody Jr. of Tampa held on the first appeal in June 2015 that bankruptcy courts have no jurisdiction over a Medicare or Medicaid dispute by virtue of Section 405(h) of Title 42 of the U.S. Code.

Section 405(h) deprives any federal court of jurisdiction over a suit against the government until the claimant has exhausted administrative remedies. Since there was no exhaustion of administrative remedies, Judge Moody set aside confirmation of the chapter 11 plan.

The nursing home appealed and lost again in an opinion for the Eleventh Circuit by Circuit Judge Raymond C. Clevenger III of the Federal Circuit, sitting by designation. Judge Clevenger's opinion is a *tour de force* on the law of codification error.

Congress's Mistake in Codification

The nursing home argued that an outcome in its favor was compelled by the plain meaning of Section 405(h), which provides that no one may sue the government "under section 1331 or 1346 of Title 28 to recover on any claim arising under" Medicare or Medicaid law until there is an exhaustion of remedies in the agency. Since the bankruptcy court was acting under power bestowed by Section 1334, not Section 1331, the nursing home contended that Section 405(h) did not apply, thus giving the bankruptcy court power to enjoin, compel assumption of the provider agreement, and decide whether the facility was in compliance with Medicare and Medicaid law and regulations.

In his comprehensive 66-page opinion, Judge Clevenger explained why the plain meaning doctrine must give way to what he called the "particular canon in statutory construction regarding the codification of law."

From 1939 to 1984, Judge Clevenger said it was "undisputed" that bankruptcy courts lacked jurisdiction over Medicare claims because Section 405(h), as adopted in 1939, deprived federal courts of jurisdiction over Medicare suits "under section 26 of the Judicial Code." At the time, Section 26 contained virtually all of the grants of jurisdiction to federal courts, including bankruptcy jurisdiction.

In 1948, Congress recodified Section 26, establishing jurisdictional grants in Section 1331 for federal questions, Section 1332 for diversity, Section 1346 for suits against the government, and Section 1334 for bankruptcy. Nonetheless, Congress did not get around to correcting Section 405(h) until 1984. In the intervening years, Section 405(h) continued referring to "section 26 of the Judicial Code" and was interpreted to mean that bankruptcy courts had no jurisdiction over Medicare and Medicaid disputes.

Congress finally recodified Section 405(h) in a technical corrections bill in 1984. The recodification produced the statute as it now reads, depriving federal courts of jurisdiction over Medicare and Medicaid disputes under Sections 1331 and 1346. The recodification made no mention of Section 1334, the grant of bankruptcy jurisdiction.

Significantly, the legislative history said that the bill was intended only to correct "technical errors." The bill itself recodifying Section 405(h) contained a provision saying that none of the amendments "shall be construed as changing or affecting any right, liability, status, or interpretation which existed (under the provisions of law involved) before" the amendments' effective date.

The Law of Codification Error

Judge Clevenger began his analysis of the law by citing Supreme Court precedent from 1884 to mean that a recodification does not effect a substantive change without a clear expression of congressional intent. He devoted the bulk of his opinion to explaining why it was "abundantly clear that Congress expressed no such intention" when it inadvertently omitted Section 1334 from Section 405(h) as the result of a "codification error."

The recodified version of Section 405(h) also omitted Section 1332. Judge Clevenger pointed out that three circuits nonetheless have held that federal courts may not exercise diversity jurisdiction over Medicaid disputes as a result of codification error.

Taking the opposite tack, the Ninth Circuit held in 1991 in *Town & Country Nursing* that the omission of a reference to Section 1334 allows bankruptcy courts to adjudicate Medicare disputes. Differing with the holding in *Town & Country Nursing*, Judge Clevenger noted that the Ninth Circuit did not analyze the legislative history accompanying the recodification.

Judge Clevenger said that the Ninth Circuit is the only appeals court to allow the exercise of bankruptcy jurisdiction in the context of a Medicare dispute. He listed the lower courts that have come down on both sides of the issue. In his district court opinion, Judge Moody said that a majority of lower courts have concluded that bankruptcy courts cannot exercise jurisdiction in view of Section 405(h).

Equitable Mootness

Even if the bankruptcy court should not have exercised jurisdiction, the nursing home argued that the appeal was moot under the doctrine of equitable mootness because the plan had been consummated. Judge Clevenger said that objections to subject matter jurisdiction can never be forfeited or waived.

Therefore, Judge Clevenger rejected the equitable mootness argument, holding that the absence of jurisdiction "precludes the exercise of that discretionary authority."

What the Opinion Means

The bankruptcy judge had said that all creditors aside from the government supported the reorganization, including a secured lender owed $11 million and unsecured creditors asserting $2 million in claims. The Eleventh Circuit's opinion means that the government by itself can overcome the wishes of creditors and the inclinations of the bankruptcy court by shutting down a health care facility when the agency finds violations of Medicare and Medicaid rules.

The opinion is *Florida Agency for Health Care Administration v. Bayou Shores SNF LLC (In re Bayou Shores SNF LLC)*, 15-13731, 2016 WL 3675462 (11th Cir. July 11, 2016).

Rabbinical court was barred from attaching an injunction under the First Amendment.

Religious Court Had No Pecuniary Interest and Thus Lacked Standing to Appeal

A religious court lacked standing to appeal and thus was unable to challenge a bankruptcy court order that allegedly violated First Amendment rights to the free exercise of religion. Unless the Second Circuit rules otherwise on standing, the Rabbinical court on its own will be unable to contest an action of a secular court that had the practical effect of enjoining proceedings in a religious community.

District Judge Cathy Seibel in White Plains, N.Y., analyzed appellate standing by analyzing whether the religious court suffered economic harm. The Sept. 27 opinion did not examine whether the bankruptcy court's injunction gave rise to standing by the Rabbinical court under the Religious Freedom Restoration Act. She made brief reference to the question of whether there was standing to assert infringement of religious rights under the First Amendment.

"The opinion is vulnerable on appeal" because there is a "serious question as to whether [the district judge] misread the standing doctrine," Prof. Burt Neuborne said in an interview. Prof. Neuborne is the Norman Dorsen Professor of Civil Liberties at the New York University School of Law.

The appeal arose after a Hasidic Jewish congregation filed a chapter 11 petition to halt foreclosure. The congregation said that bankruptcy was precipitated by alleged wrongdoing by its former board of trustees, ultimately resulting in payment defaults to a secured lender.

In bankruptcy, the congregation sued a Jewish school and several individuals for recovery of fraudulent transfers. The school and the individuals invoked a *beis din*, a Jewish court of law. The Rabbinical court then "invited" the bankrupt congregation's principals – but not the congregation itself – to participate in proceedings to resolve the disputes that underlay the adversary complaint in bankruptcy court.

The Rabbinical court directed the principals to discontinue proceedings in bankruptcy court. If the individuals did not follow the Rabbinical court's directions, they could be subject to the equivalent of a contempt decree that could exclude them from the schools and worship services.

The bankrupt congregation initiated contempt proceedings in bankruptcy court, where the judge eventually found a violation of the Section 362 automatic stay. Finding in part that there was no violation of the First Amendment, the bankruptcy judge enjoined the individual defendants and the school from continuing the *beis din* and directed them to discontinue proceedings in the Rabbinical court. If they failed to obey the injunction, the bankruptcy court's order called for a $10,000 sanction against each defendant for each day in defiance of the order. The bankruptcy court also scheduled a later hearing to rule on actual and punitive damages for violation of the automatic stay.

The Rabbinical court, not itself a defendant in contempt proceeding in bankruptcy court, filed an appeal from the injunction. The individuals and the school did not pursue an appeal because they settled.

Judge Seibel raised the issue of appellate standing *sua sponte* and directed the Rabbinical court and the bankrupt congregation to file letter briefs not more than five pages in length.

Judge Seibel dismissed the appeal for lack of appellate standing.

She recited familiar law to the effect that standing to appeal is a "more exacting" concept than the case or controversy requirement for Article III standing. In the Second Circuit, she said, someone must "be directly and adversely affected pecuniarily" to have appellate standing.

Although she conceded that "the injury need not be financial," Judge Seibel said the additional requirement of "prudential standing" demands that an appellant "must assert his own legal rights and not those of third parties."

With those principles in mind, Judge Seibel said that the effect of the injunction on the Rabbinical court was "indirect" and "insufficient to confer standing." Even if there were a direct effect, she said "it is not pecuniary."

To the argument that the injunction impinged on the Rabbinical court's constitutional rights, Judge Seibel cited the Seventh Circuit for the proposition that there must be pecuniary injury to bestow standing to allege infringement of the First Amendment.

Because the Rabbinical court's lack of standing resulted in dismissal of the appeal, Judge Seibel said she could not decide constitutional issues.

On behalf of the Rabbinical court, Prof. Neuborne submitted an *amicus* brief in district court on the merits but not on the question of appellate standing.

The opinion is *Bais Din of Mechon L'Hoyroa v. Congregation Birchos Yosef (In re Congregation Birchos Yosef)*, 15-cv-6408 (S.D.N.Y. Sept. 27, 2016).

Tender Offers in Bankruptcy

Third Circuit holds again that equal treatment is not required in settlements.

Tender Offers in Bankruptcy Pass Muster in the Third Circuit

A tender offer that might not be possible outside of bankruptcy court is permissible in the Third Circuit, as the result of a May 4 opinion stemming from the reorganization of Energy Future Holdings Corp., the giant Dallas-based power generator and distributor whose chapter 11 plan was confirmed in December but not yet implemented.

In a decision that "does not constitute binding precedent" under Third Circuit rules, the appeals court held that the tender offer proposed by Energy Future "clearly did not violate the Bankruptcy Code." The opinion by Circuit Judge Patty Shwartz said the offer was not forbidden by any provision in the Bankruptcy Code.

The indenture trustee characterized the process as a tender offer because the company made the proposal to creditors before the procedure was approved by the bankruptcy court. Judge Shwartz said, "[I]t was simply a means to convey a settlement offer to certain creditors." The offering materials were given to creditors without prior approval by the Securities and Exchange Commission.

Energy Future filed for reorganization in April 2014 and got bankruptcy court approval in June 2014 to settle with holders of two issues of first-lien notes issued by the subsidiary that owns 80 percent of the company's regulated Oncor power-line business. In substance, the bankruptcy court approved procedures and the settlement itself after the company had solicited acceptances.

The settlement allowed Energy Future to pay off first-lien debt with 5 percent extra for holders who gave up claims for a so-called make-whole, a premium for investors when their bonds are paid off early. The settlement was financed with a $5.4 billion loan approved by the bankruptcy court at the same time.

The indenture trustee for one of the noteholder groups appealed and contended that the settlement was a coercive tender offer that would not pass muster outside bankruptcy and should not have been allowed in bankruptcy, either. The district court in Delaware upheld the settlement in February 2015 and was affirmed by the Third Circuit over the indenture trustee's objection that the process established a precedent opening "a Pandora's Box of coercive tender offers in chapter 11."

Although approval of the offer by the bankruptcy court in advance "may be preferable where possible," Judge Shwartz saw "no reason to hold that the order of events dictates whether a settlement achieved by a tender offer is fair and equitable." She examined the standards for approving settlements and found that none were violated.

The indenture trustee also contended that the offer violated the "equal treatment" rule in Section 1123(a)(4) because one set of noteholders got a 62 percent recovery of the make-whole premium, while the return was only 25 percent for the other "identically situated" group.

Citing the Third Circuit's *Jevic* opinion from last year, Judge Shwartz said that the absolute priority and equal-treatment rules "are not categorically applied in the settlement context." A *certiorari* petition in *Jevic* is pending in the Supreme Court.

Even though the bankruptcy court could have approved a settlement with unequal treatment if there were "adequate reason for doing so," the appeals court said that "there was in fact equal treatment" because bondholders who rejected the settlement still had the right to make a claim for the entire make-whole.

"Mere differences in potential final outcomes resulting from choices made by individual creditors do not violate equal treatment protections in Section 1123(a)(4)," Judge Shwartz said.

The opinion is *Delaware Trust Co. v. Energy Future Holdings Corp. (In re Energy Future Holdings Corp.)*, 15-1591, 2016 WL 2343322 (3d Cir. May 4, 2016).

Plans & Confirmation

Circuit erroneously cites Section 1325
as governing in chapter 11 cramdown.

Ninth Circuit Makes Glaring Error in Chapter 11 Cramdown Opinion

The Ninth Circuit wrote a seminal 2-1 opinion on the reorganization of affordable housing projects in chapter 11. Repeatedly, the opinion erroneously cites Section 1325 as the governing cramdown statute, when the appeals court should have been referring to Section 1129.

The court quickly corrected the mistake by changing references to Section 1325 to Section 1129. Nonetheless, the opinion will make reorganization virtually impossible for owners of affordable housing when the lender is bent on taking title, unless the result is modified on rehearing.

The majority admit that the precedent will result in fewer affordable housing units.

The dissent, by Circuit Judge Richard A. Paez, argues that the majority misread the Supreme Court's 1997 decision in *Rash* by basing valuation on the creditor's perspective. Judge Paez also points out that the majority's approach to valuation under Section 506(a) is at odds with the *Collier* bankruptcy treatise.

All three judges agreed that the appeal was not moot, making the Ninth Circuit an even more dangerous forum for purchasers or investors in bankrupt properties.

"The opinion should alert judges that their clerks ought to have taken bankruptcy if they are going to write published opinions on the subject," Prof. Bruce A. Markell of Northwestern Univ. Pritzker School of Law said in an e-mailed statement reflecting on the miscitation of Section 1325. Prof. Markell was a bankruptcy judge in Nevada and a member of the Ninth Circuit Bankruptcy Appellate Panel before he returned to teaching in 2013.

The project had an $8.5 million, government-guaranteed first mortgage and two subordinate mortgages. Following default on the first mortgage, the government paid off the first lien lender and sold the mortgage to a third party for about $5 million. The new owner of the mortgage had arranged to sell the property after foreclosure for about $7.7 million. To halt foreclosure, the owner of the project filed a chapter 11 petition.

The three mortgages and agreements related to affordable housing all provided that the restrictions related to affordable housing would terminate in the event of foreclosure. The project had not been foreclosed by the time the circuit court issued its opinion on April 8.

The project's owner financed the reorganization with $1.2 million in new equity provided by a new investor who in substance took over ownership when the plan was confirmed and consummated. As confirmed by the bankruptcy court, the plan valued the first lien at $3.9 million. Although not mentioned in the opinion, the lender exercised the Section 1111(b) election. Consequently, the plan gave the lender a new note, with interest, where the full amount of the debt would be paid on maturity of the loan in 40 years.

The new investor agreed to continue operating the property as an affordable housing project. The project's expert conceded that it would be worth $7 million if affordable housing restrictions did not apply.

The lender appealed and was denied stays in the bankruptcy and district courts. The district court later upheld the confirmation order, leading to a reversal in the majority opinion written by Circuit Judge Richard R. Clifton.

The governing Supreme Court authority, of course, is *Rash*, a chapter 13 case involving valuation of a truck under Sections 1325 and 506(a). In the first paragraph of the opinion and later, Judge Clifton cited Section 1325 as containing the relevant cramdown standard, not Section 1129, which should have been applicable because the case entailed an appeal arising from a chapter 11 reorganization.

Judge Clifton said that valuation, governed by Section 506(a), is not measured by the income an owner could generate by operating the property as affordable housing. He said that nothing under Section 1325(a)(5) authorizes "shortchanging the creditor with regard to its current secured value." He said that *Rash* does not authorize reducing the value simply because bankruptcy prohibits the lender from foreclosing, when affordable housing restrictions would end as a matter of contract.

Judge Clifton admitted there will be a "negative effect" by eliminating use of the project as affordable housing. Although that result would be "unfortunate" in "an immediate sense," he said that the lower courts' decisions "would drastically reduce" what the government could gain from selling defaulted mortgages. He added that the government could have designed financing so the property would remain affordable housing even after foreclosure.

Dissenting, Judge Paez said that the "majority errs in several major respects, all relating to its misapplication" of *Rash*. Saying that *Rash* "rejected starting the valuation from the creditor's perspective," he cited *Collier's* statement that the amount paid to a secured creditor under Section 506(a) "turns on the value of the debtor's proposed use of the relevant property under the plan, not the value achievable in a foreclosure scenario that is not proposed."

Citing the Ninth Circuit's *Transwest* decision from 2015, Judge Paez agreed with the majority in finding that the appeal was not equitably moot.

Conversely, the debtor contended that the appeal was equitably moot because reversal would be unfair to the third party that already had invested $1.2 million and would incur tax penalties were the transaction unraveled. The appeals court said that the new investor "is not the kind of innocent third party the doctrine of equitable mootness is intended to protect." The investor, according to Judge Clifton, knew there were "potential tax risks if something went wrong."

The appeals court also dispensed with the previously imposed requirement that an appellant must pursue a stay pending appeal in the circuit court to avoid equitable mootness. Because the appeals court rarely grants stays in these circumstances, the circuit said that a third futile stay motion was not required.

Transwest, also a 2-1 opinion, held that a buyer who actively participates in reorganization is not protected by equitable mootness. *Transwest*, combined with the new opinion, implies that investors or owners should think long and hard before consummating sales or plans if there is an outstanding appeal in the Ninth Circuit. The opinion gives more ammunition to lawyers advising their clients not to file chapter 11 petitions in the Ninth Circuit.

Unless an existing owner can somehow escape the restrictions associated with affordable housing projects, a lender intent on taking ownership should always be able to defeat a reorganization plan in the Ninth Circuit, taking low-cost units out of the housing market in the process.

The opinion is *First Southern National Bank v. Sunnyslope Housing LP (In re Sunnyslope Housing LP)*, 818 F.3d 937 (9th Cir. April 8, 2016).

Rochelle's Daily Wire

Sixth and Fifth Circuits arguably disagree on what constitutes artificial impairment to confirm a chapter 11 plan.

Sixth Circuit Nixes the Notion of Artificial Impairment for Plan Confirmation

"Artificial impairment" as a means for cramming down a chapter 11 plan on a recalcitrant secured creditor is a theory that does not hold water in the Sixth Circuit when very little unsecured debt takes a haircut, even in the face of an explicit bankruptcy court finding that the plan was proposed in good faith as the result of economic necessity.

The Sixth Circuit's opinion on Jan. 27 is arguably at odds with a 2013 case from the Fifth Circuit.

The debtor owed $8.6 million on a mortgage securing an apartment building worth $5.4 million. Aside from the lender, the only creditors were the debtor's accountant and lawyer, whose unsecured claims totaled $2,400.

To create an impaired class of accepting creditors, the plan proposed paying the unsecured claims in full over 60 days. The bankruptcy court's confirmation order was reversed by the district judge, who set aside findings of fact as clearly erroneous.

The opinion by Circuit Judge Raymond M. Kethledge on Jan. 27 upheld the district court and could be interpreted as a broad rejection of the notion of artificial impairment in the Sixth Circuit.

To uphold rejection of the plan, Judge Kethledge first held that a good faith requirement is not engrafted onto Section 1129(a)(10), which requires acceptance by one impaired class. He said that contrived impairment is "immaterial" because Section 1124(1) only asks whether creditors' interests are altered, not "whether the debtor had bad motives."

Invoking the Fifth Circuit's 2013 *Camp Bowie* decision, Judge Kethledge next held that the debtor's motives instead are the province of Section 1129(a)(3), which requires that plans be proposed in good faith.

At that juncture, Judge Kethledge ran into a potential roadblock because the bankruptcy judge had found that the plan was filed in good faith as a result of economic necessity. The circuit court determined that the finding of fact was clearly erroneous because the lender had offered to pay unsecured creditors in full immediately.

The appeals court also said that the debtor's close alliance with the unsecured creditors compounded the appearance that impairment "had more to do with circumventing" Section 1129(a)(10) than with "rationing dollars."

Although Judge Kethledge cited *Camp Bowie*, his opinion may be at odds with the Fifth Circuit's holding. In *Camp Bowie*, the circuit court held that the Bankruptcy Code makes no distinction between adverse effects on claim holders that result from economic necessity and those arising from the bankrupt's discretion.

Like the Sixth Circuit, the Fifth held in *Camp Bowie* that a bankrupt company's ability to pay claims in full remains an issue on the question of whether the plan is proposed in good faith. In the Fifth Circuit case, now-retired Bankruptcy Judge Michael Lynn found good faith.

So why were the results different in the two circuits? Does the Sixth Circuit have a lower standard for reversing findings of fact?

The difference might be attributed to the relative amount of unsecured debt. In *Camp Bowie*, the impaired unsecured debt was 0.2% of the secured debt. In the Sixth Circuit case, impaired unsecured debt was only 0.03% of secured debt. Is that reason enough for a different result? Can a lender defeat a finding of good faith by offering to pay unsecured claims in full?

The two cases may have other important factual distinctions, because the lender in *Camp Bowie* agreed that the owner could remain current on the revised mortgage and that the property was worth more than the debt. In the Sixth Circuit case, the property was worth a fraction of the mortgage debt and would be paid down little during the life of the plan.

Other factual differences may be important, too. In *Camp Bowie*, the bankruptcy judge required the owners to contribute $1.5 million in new equity and precluded them from taking money out until the lenders were fully paid. Nonetheless, the Fifth Circuit said that the plan fit within the "plain meaning of Sections 1124 and 1129(a)(10)" of the Bankruptcy Code.

There can be debate as to whether the two cases are at odds or merely reflect different underlying facts. While there may be no bright-line test to determine when a small amount of impairment is too little, the Sixth Circuit may be quicker to find artificial impairment, at least when the lender is taking a haircut and the debtor's owners are injecting no new capital.

In any event, it does not appear that the two cases are sufficiently inconsistent to warrant Supreme Court review because the two courts' pronounced legal principles are not far apart.

The opinion is *Village Green I GP v. Fannie Mae (In re Village Green I GP)*, 811 F.3d 816 (6th Cir. Jan. 27, 2016).

ROCHELLE'S DAILY WIRE

No need for venue-shopping between Delaware and New York for undersecured creditors.

Judges Sontchi and Drain Agree on Treatment Among Undersecured Creditors

Neither Delaware nor New York provides better treatment for lienholders with higher interest rates when it comes to distributions among undersecured creditors.

In a 38-page opinion on March 11 in the reorganization of Energy Future Holding Corp., Bankruptcy Judge Christopher S. Sontchi of Delaware agreed with New York Bankruptcy Judge Robert Drain by holding that post-petition interest accruals are not taken into consideration when calculating distributions among undersecured creditors with liens on the same collateral.

The decision turned on Judge Sontchi's interpretation of the intercreditor agreement among first lien creditors whose collateral was insufficient to pay their collective claims in full. Consequently, first lien creditors were not entitled to post-petition interest.

The interest rate on first lien notes was higher than the interest rates on other first lien debt. The indenture trustee for first lien noteholders nonetheless argued that the hypothetical accrual of post-petition interest should be taken into consideration when parceling out distributions under the confirmed chapter 11 plan. Among other things, the plan gave first lien creditors stock in a reorganized company, cash, new debt, and the ability to purchase more stock in an equity rights offering.

Agreeing with Judge Drain's decision in the reorganization of MPM Silicones LLC, also known as Momentive Performance, Judge Sontchi held that property distributed under the plan was not collateral on which the creditors held liens. Therefore, he said, the intercreditor agreement did not apply.

He also held that plan distributions, including cash, did not fall under the intercreditor agreement's definition of "proceeds" because they did not flow from the sale or disposition of collateral.

Judge Sontchi reached the same conclusion with respect to distributions of adequate protection payments under the cash collateral order.

As a result, undersecured creditors will receive distributions in proportion to what they were owed at the outset of bankruptcy, in the process disregarding hypothetical post-petition interest accruals.

Judge Sontchi said there were no disputed issues of fact. He also held that the intercreditor agreement was unambiguous.

The opinion is *Delaware Trust Co. v. Wilmington Trust Co. (In re Energy Future Holdings Corp.)*, 546 B.R. 566 (Bankr. D. Del. March 11, 2016).

Section 1111(b) election does not require a due-on-sale clause in a restructured mortgage.

Courts Split on Per-Plan or Per-Debtor Acceptance for Cramdown Confirmation

On an issue dividing the lower courts, a district judge in Arizona took sides with the bankruptcy court in New York by holding that every debtor in a joint plan is not required to have an accepting impaired class before the court can confirm using cramdown.

Differing with the bankruptcy court in Delaware, Chief District Judge Raner C. Collins of Tuscon, Ariz., concluded that Section 1129(a)(10) does not require every debtor in a joint plan to have an accepting impaired class. The decision is on appeal to the Ninth Circuit.

In the reorganization of a hotel involving five debtors that were not substantively consolidated, one lender held both the mortgage debt and the secured mezzanine debt . The secured lender voted both claims against the plan.

The joint plan for all five debtors had 10 classes of creditors. Five accepted the plan. Because the mezzanine lender had the only claim against two mezzanine borrowers, the lender contended that cramdown requirements were not met because those two debtors had no accepting class.

The bankruptcy judge confirmed the plan and was upheld by Judge Collins, who ruled that each debtor in a consolidated plan is not required to have an accepting class. He cited cases from the bankruptcy court in Delaware, which requires that each debtor must have an accepting class.

Judge Collins said in his June 22 opinion that the statute's plain language is dispositive because it allows confirmation if accepted by "one class of claims that is impaired *under the plan*...."

The decision is also important because Judge Collins did not require a cramdown plan to contain a due-on-sale clause when a secured lender takes the Section 1111(b)(2) election.

For $209 million in mortgage debt that originally had no due-on-sale clause, the plan gave the lender a new $247 million note due in 21 years, paying interest only. The new mortgage contained a due-on-sale clause. The plan was sponsored by a purchaser who invested $30 million to acquire the equity.

If the buyer sold the project between the fifth and fifteenth years, the plan provided that the due-on-sale clause would not apply. Instead, a buyer in the 10-year gap would take ownership subject to the mortgage created at confirmation.

The lender contended that the 10-year exception to the due-on-sale clause depressed the value of the Section 1111(b)(2) election. Judge Collins held that the plain language of that statute does not give the lender an "absolute right" to a due-on-sale clause. Likewise, he said, the cramdown provision in Section 1129(b)(2)(A) "also makes no reference to any such requirement."

Judge Collins noted that the original loan had no due-on-sale clause. In addition, the lender's right to approve a new owner was carried over from the "old" mortgage, and the lender would receive an assumption fee in the event of a sale.

Judge Collins' decision was the progeny of *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc.* (*In re Transwest Resort Properties Inc.*), 801 F.3d 1161 (9th Cir. Sept. 15, 2015), where the Ninth Circuit held over a vigorous dissent that a buyer who actively participates in reorganization is not protected by the doctrine of equitable mootness should a creditor appeal but not obtain a stay, preventing consummation of the plan. Denying a motion for rehearing *en banc*, the circuit remanded the case to Judge Collins, who had originally dismissed the appeal as equitably moot. On remand, Judge Collins upheld confirmation on the merits.

The opinion is *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc.* (*In re Transwest Resort Properties Inc.*), 12-024 (D. Ariz. June 22, 2016).

Delaware's Judge Kevin Gross declines to follow prior decision by visiting judge.

Gift Cards Denied Priority Status in Delaware, Contravening Prior Delaware Decision

Unredeemed gift cards do not give rise to priority claims under Section 507(a)(7), according to a decision by Bankruptcy Judge Kevin Gross of Delaware in the liquidation of retailer City Sports Inc.

Judge Gross concluded in his Aug. 4 opinion that both the plain language of the statute and legislative history require denial of priority status. He disagreed with the conclusion in a 2004 Delaware case called *WW Warehouse Inc.*, written by now-retired Bankruptcy Judge Joel Rosenthal of Massachusetts, who was a visiting judge.

Section 507(a)(7) allows a seventh-priority claim, now $2,850, "arising from the deposit" of money "in connection with the purchase" of "property, or the purchase of services, for personal, family or household use . . . that were not delivered or provided."

In the prong of his decision focusing on statutory language, Judge Gross focused on the word "deposit," which has a "temporal relationship" that "expressly applies to incomplete transactions, that is, transactions requiring additional steps to reach completion."

In his view, transactions involving money orders, store credit or gift cards are transactions that were completed when they were issued. Judge Gross said he was "unwilling to apply a potentially unlimited transactional duration to gift card purchases."

Although he believes the statute by itself is "clear and unambiguous," Judge Gross acknowledged that some courts found the section ambiguous. He therefore studied legislative history and reached the same conclusion.

"At first sight," Judge Gross admitted that legislative history might indicate priority status. "On closer examination," he found "that Congress likely did not intend to protect gift card consumers." He based his conclusion in part on the House Report that listed layaway plans and merchandise deposits as being covered but did not mention gift cards, which some scholars had urged to be covered by the then-proposed amendment.

Judge Gross said that the "reason Congress omitted gift card holders is not clear."

The decision "may be purely academic," Judge Gross said, because the case might be administratively insolvent, leaving nothing to pay gift card claims even if they qualified for priority status.

The opinion is *In re City Sports Inc.*, 15-12054 (Bankr. D. Del. Aug. 4, 2016).

Stays & Injunctions

ROCHELLE'S DAILY WIRE

Posner singlehandedly turns Chicago into a more desirable forum for large chapter 11s.

Seventh Circuit Lays Down an Easy Standard for Enjoining Suits Against Third Parties

Addressing what he called the "immense and immensely complicated" reorganization of casino giant Caesars Entertainment Operating Co. Inc., Seventh Circuit Judge Richard A. Posner penned an important opinion on Dec. 23 reversing the lower courts and establishing an easily satisfied test allowing the bankruptcy court to enjoin lawsuits in other courts against nondebtor third parties, including nonbankrupt affiliates.

Junior bondholders had filed four lawsuits in Delaware state court and a Manhattan federal district court seeking to reinstate the nonbankrupt parent's guarantees of the noteholders' bonds. The guarantees had been extinguished in two transactions in 2014 before the casino operating company filed for reorganization.

Upheld in district court in October, the bankruptcy judge had concluded in July that he lacked the power to enjoin the junior bondholders' suits against the nonbankrupt parent. The bankruptcy judge believed that Seventh Circuit precedent permitted injunctions halting suits by creditors against nonbankrupts only when the creditors were suing on claims also available to the debtors.

In reporting the district court opinion, we noted that Judge Posner was on the panel that heard the appeal on Dec. 10. We said it was "a safe bet that Judge Posner will write the circuit's opinion, because he seldom misses a chance to make a significant pronouncement on bankruptcy."

That is exactly what happened. Judge Posner said the lower courts misinterpreted the circuit's precedents in 1998 and 2009, called *Fisher* and *Teknek*, respectively. To justify an injunction halting suit against a nonbankrupt third party, he established a two-part test.

First, the bankruptcy judge must decide whether an injunction "is likely to enhance the prospects for a successful resolution of the disputes attending its bankruptcy." Second, the court has power to enjoin under Section 105(a) if denial would "endanger the success of the bankruptcy proceedings."

Although Judge Posner said he was not compelling the bankruptcy judge to issue an injunction on remand, he all but told the lower court how to rule. He said the interests of the operating company's creditors would be "furthered" by an injunction if the bondholders' suits outside of bankruptcy court would drain the nonbankrupt parent of capital, leaving "much less money" for other creditors to recover in bankruptcy.

In that regard, Judge Posner seems to have bought into the debtor's argument that the suits, if not enjoined, might enable the bondholders to "jump the line in front of other creditors, including more senior ones."

Defeating the injunction on remand is not an impossible dream for the bondholders, however.

Since the suits in New York are near conclusion, the bondholders can argue that the Manhattan district judge should be permitted to rule on the legality of cancelling the guarantees, with the understanding that an injunction would then kick in, preventing the bondholders from exercising remedies against the nonbankrupt parent.

Even in the absence of an injunction, a judgment in New York reinstating the guarantees would not by itself enable the bondholders to "jump the line" because the parent could then file under chapter 11, putting the bondholders on the same footing as other unsecured creditors.

Judge Posner said that *Fisher* and *Teknek* had more "clear-cut" facts permitting injunctions. Those cases, he said, did not mean that a "less clear-cut case is necessarily beyond the reach of section 105(a)."

The opinion is *Caesars Entertainment Operating Co. Inc. v. BOKF NA (In re Caesars Entertainment Operating Co. Inc.)*, 808 F.3d 1186 (7th Cir. Dec. 23 2015).

Despite concurrent jurisdiction, courts are split on Rooker-Feldman and the stay.

Rooker-Feldman Is No Bar to Overruling a State Court on the Automatic Stay

If a state court rules on the applicability of the automatic stay, is the decision binding on the bankruptcy court under the *Rooker-Feldman* doctrine?

The courts are split.

Bankruptcy Judge James R. Sacca of Atlanta came down on the side of the Third and Ninth Circuits by holding that bankruptcy courts can review decisions of state courts on the automatic stay. He disagreed with the Sixth Circuit Bankruptcy Appellate Panel and bankruptcy courts in New York and Florida.

Judge Sacca's case was more difficult because a non-bankrupt third party sought to revisit the state court's decision. Moreover, the debtor's liability evidently would not have been affected whichever way the courts ruled.

Judge Sacca began his analysis on June 24 by remarking that the stay "is one of the most fundamental protections" in the Bankruptcy Code. Significantly, he said, bankruptcy courts have exclusive jurisdiction to grant relief from the stay. In addition, state court suits in violation of the stay are void *ab initio*.

Thus, he concluded that he was not bound by the state court's ruling on the stay, although he conceded that state courts have concurrent jurisdiction to rule on the applicability of the stay.

On the merits of the alleged stay violation, Judge Sacca held that the stay did not apply because the suit in state court affected only the separate liability of a garnishee for failing to set aside the debtor's wages before bankruptcy.

The opinion is *Southwest Airlines Co. v. Tidewater Finance Co. (In re Cole)*, 15-70960 (N.D. Ga. June 24, 2016).

Equitable Mootness

Another circuit joins the trend toward limiting the doctrine of equitable mootness.

Second Circuit May Be Trimming Back Doctrine of Equitable Mootness

The Second Circuit trimmed back the doctrine of equitable mootness used to dismiss appeals from chapter 11 plans that have been consummated.

The appeal was brought by an 8% shareholder from confirmation of the LightSquared Inc. reorganization plan. The unsigned, summary opinion on March 22 held that the appeal was "presumed equitably moot" because the plan had been substantially consummated.

The appeals court held that the shareholder satisfied all five tests required for overcoming the presumption of mootness. On the critical test, the circuit court said it could grant "at least some effective relief in the form of monetary damages in this case – even as little as one dollar – without knocking the props out from under the completed transaction."

Avoiding dismissal ultimately failed to help the shareholder because the circuit court proceeded to rule on the merits by finding that LightSquared's plan did not violate the "fair and equitable" rule. The bankruptcy judge made an adequately based finding that the reorganized company had no equity for "old" shareholders.

The Second Circuit opinion could be read as bringing that court more in line with other appeals courts that have been narrowing the doctrine of equitable mootness. The Second Circuit approvingly cited the Fifth Circuit's 2013 decision in *Texas Grand Prairie Hotel Realty LLC*, where the New Orleans-based court took a "narrow view" of equitable mootness, "particularly where pleaded against a secured creditor." *Texas Grand Prairie* said that equitable mootness only protects creditors who are not parties to the appeal.

The Second Circuit also approvingly cited the Ninth Circuit's *Transwest Resort Properties* decision from 2015. In that case, the Ninth Circuit held, over a vigorous dissent, that a buyer who actively participates in reorganization is not protected by equitable mootness. The Ninth Circuit denied motions for rehearing *en banc*.

By citing the other two circuits, it is far from clear, however, that the Second Circuit is going equally far in trimming back equitable mootness. The significance of the opinion is also limited because it was a summary order intended to have limited precedential effect.

The Second Circuit opinion is *Ahuja v. LightSquared Inc.*, 15-2480, 2016 WL 1105109 (2d Cir. March 22, 2016).

ROCHELLE'S DAILY WIRE

The Ninth Circuit provides another reason to avoid reorganizing on the West Coast.

Ninth Circuit Won't Protect Purchasers with Equitable Mootness

The Ninth Circuit is now more firmly ensconced as a jurisdiction an investor should avoid when bent on buying a company through chapter 11.

In July, a three-judge panel held 2-1 that a buyer who actively participates in reorganization is not an innocent third party protected by the doctrine of equitable mootness, a judge-made rule of law allowing dismissal of an appeal without reaching the merits.

The reorganized company filed a motion for panel rehearing and rehearing *en banc*. The original three-judge panel withdrew its July opinion and issued a new opinion on Sept. 15, reaching the same result by the same rationale and by the same 2-1 vote. The revised opinion only made matters worse for investors arguing in the future in the Ninth Circuit that a confirmation appeal is moot after consummation of a plan.

The circuit nailed the coffin shut on Oct. 23 by denying the motion for *en banc* rehearing. No judge even sought a vote regarding *en banc* rehearing. Some debtors already avoid reorganizing in the Ninth Circuit because that court categorically precludes third-party releases.

The case involved a real estate project in which the lender exercised its option under Section 1111(b) of the Bankruptcy Code to keep the full amount of its lien on the property with an agreed value of $92 million. The due-on-sale clause in the mortgage, coupled with the election, would ordinarily mean that the lender could collect all sale proceeds were the property to be sold after emergence from chapter 11 because the claim was several times the value of the project.

The plan was confirmed over the lender's objection. It provided that the lender would not receive all sale proceeds that were the project sold between the fifth and fifteenth years after confirmation. The plan was sponsored by a purchaser who was committed to investing $30 million in the property after bankruptcy.

The lender quickly, though unsuccessfully, sought stays of the confirmation order in both the bankruptcy court and the district court. After the district court denied a stay pending appeal, the judge dismissed the appeal on the ground of equitable mootness. The lender was contesting the 10-year hole in the due-on-sale clause.

The lender appealed to the circuit and won in a revised panel opinion on Sept. 15. Writing the opinion for the majority, Circuit Judge Michelle T. Friedland reinstated the appeal and sent it back to the district court to consider the merits and decide how to modify the plan if the lender succeeded in overturning the confirmation order. Because the buyer had already invested to upgrade the property, Judge Friedland said that relief on appeal could be less than reinstatement of the entire due-on-sale clause.

Judge Friedland said the purchaser, despite its obligation to invest $30 million, is not "the type of an innocent third party that the equitable mootness doctrine is meant to protect" because the buyer participated "at every stage of these proceedings."

Citing the Fifth Circuit's 2009 opinion in *Pacific Lumber*, Judge Friedland said that "appellate consequences are foreseeable" when a sophisticated investor crafts a plan that "presses the limits" of bankruptcy law.

Judge Friedland declined to adopt a presumption, used by other circuit courts, that a plan is moot once implemented.

Circuit Judge Milan Dale Smith Jr. dissented, saying the result was "grossly inequitable." He believes the majority's opinion "discourages potential investors from relying on the finality of bankruptcy court confirmation orders."

The majority's new opinion corrected a mistake in the original July decision, in which the appeals court had said that the investor was a party to the circuit court appeal. Even though it did not participate in the appeal, the majority said the investor still was not an innocent third party protected by equitable mootness, in part because it went ahead with plan confirmation in the face of the lender's objection.

The opinion is *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc.* (*In re Transwest Resort Properties Inc.*), 801 F.3d 1161 (9th Cir. Sept. 15, 2015).

Safe Harbor

***Judge Gross finds Judge Gerber in* Lyondell *more persuasive than the Second Circuit in* Tribune.**

Delaware's Judge Gross Differs with Second Circuit on the Safe Harbor

In March, the Second Circuit handed down *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, slamming the door on virtually every theory finding a loophole in Section 546(e), one of the safe harbor provisions in the Bankruptcy Code barring suits to recovery payments made in securities transactions.

Bankruptcy Judge Kevin Gross in Delaware wrote a decision on June 20 where he disagreed with *Tribune*. Saying that Second Circuit authority is not binding on him, Judge Gross adopted the approach taken in the 2014 *Lyondell Chemical Co.* opinion, where former Bankruptcy Judge Robert E. Gerber of Manhattan held that the safe harbor only bars trustees from suing, not creditors from asserting claims of their own.

Judge Gross' opinion reads like a brief to the Third Circuit, distinguishing *Tribune* and explaining why the Second Circuit was wrong by holding that Congress intended to preempt state laws in adopting Section 546(e).

The Facts in *Physiotherapy*

A company called Physiotherapy Holdings Inc. filed under chapter 11 not long after being acquired in a leveraged buyout where two controlling shareholders sold 90% of the stock they controlled. A litigation trust filed suit against the controlling shareholders to recover almost $250 million they received by selling their stock in the LBO.

Pre-LBO senior noteholders assigned their claims to the litigation trust, constituting the backbone of the suit. The complaint alleged that the LBO was both a constructive fraudulent transfer and a fraudulent transfer with "actual intent." The complaint asserted claims under both Section 548 and parallel provisions in Pennsylvania's Fraudulent Transfer Act.

According to the complaint, the defendants were not innocent selling shareholders. The trust alleged that the controlling shareholders knew the company was issuing false financial statements grossly overstating net income, thus enticing the purchaser to acquire the company in the LBO.

The selling shareholders filed a motion to dismiss. Judge Gross denied the motion with respect to the actual fraud claim under Section 548(a)(1)(A) and the senior noteholders' constructive fraud claim under state law. He dismissed the complaint's claims for constructive fraudulent transfers under Section 548(a)(1)(B) and the trustee's claims for actual and constructive fraudulent transfers under state law.

The Safe Harbor and *Tribune*

The safe harbor in Section 546(e) provides that "the trustee may not" sue for recovery of a "settlement payment" made in connection with a "securities contract" unless the suit is brought under Section 548(a)(1)(A) for recovery of a fraudulent transfer within two years of bankruptcy made with actual intent to hinder, delay or defraud creditors.

The statute's reference to a trustee prompted litigation contending that the safe harbor does not bar suits based on the creditors' own claims, as opposed to claims brought by a trustee. Judge Gross' opinion analyzes the decisions coming down on both sides of the issue. His focus, of course, is on *Tribune* and *Lyondell*.

In *Tribune*, the bankruptcy judge had allowed company retirees, along with pre-LBO unsecured bondholders, to sue selling shareholders using constructive fraudulent transfer theories. After plan confirmation, the litigation trust took over prosecution of the creditors' claims. In the Second Circuit's March decision, the appeals court dismissed the creditors' state law claims under Section 546(e) on a theory of implied preemption of state law.

The Second Circuit held that state law constructive fraudulent transfer claims were preempted because "unwinding settled securities transactions" would "seriously undermine" the markets.

The *Tribune* opinion effectively overruled *Lyondell*, which held that the safe harbor does not preclude fraudulent transfer suits based on state law, nor does it protect selling shareholders who ultimately received proceeds from allegedly fraudulent transfers.

Judge Gross' Analysis

Saying that *Lyondell's* reasoning was "more persuasive" than *Tribune*, Judge Gross adopted *Lyondell's* holding. He said that *Lyondell* "more accurately addresses the history and function of the safe harbor." He cited the Supreme Court's *Wyeth* decision from 2009, which said that the states' police powers cannot be superseded "unless that was the clear and manifest purpose of Congress."

Quoting from the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 with regard to the history and purpose of Section 546(e), Judge Gross said the safe harbor was designed to avoid a "ripple effect" in the securities markets if transfers of securities were set aside in bankruptcy.

Judge Gross does not believe that allowing state law claims to proceed would destabilize the securities markets. He pointed out that that no public shareholders were involved, and the controlling shareholders had 90% of the stock. He also said that the statute only limits a trustee's ability to sue and is "silent with regard to a creditor's ability to bring such a claim."

In contrast to his case where the selling shareholders allegedly were aware of false financial statements enabling the LBO, Judge Gross noted that the selling shareholders in *Tribune* "were not alleged to have acted in bad faith." Therefore, he said that barring suit would "run counter to Congress' policy of providing remedies for creditors who have been defrauded by corporate insiders."

The language of the statute nonetheless constrained Judge Gross to dismiss claims explicitly precluded by the safe harbor.

To read ABI's discussion of *Tribune*, click here.

The opinion is *PAH Litigation Trust v. Water Street Healthcare Partners LP (In re Physiotherapy Holdings Inc.)*, 15-ap-51238, 15-ap-51238 (Bankr. D. Del. June 20, 2016).

Creditors, not just trustees, are also barred from suing by Section 546(e).

Second Circuit Closes Loopholes in 'Safe Harbor' to Protect Selling LBO Shareholders

[Note: The opinion, originally issued on March 24, was "filed in error and stricken from the record" by a docket entry on March 28. The next day, the appeals court reissued the opinion with immaterial changes. The circuit denied rehearing *en banc* on July 22.]

Broadly interpreting the safe harbor for "settlement payments" provided by Section 546(e) of the Bankruptcy Code, the Second Circuit triple-locked the door against individual creditors trying to sue shareholders for the recovery of payments received in a leveraged buyout before the company filed bankruptcy.

In a March 24 opinion by Circuit Judge Ralph K. Winter Jr., the appeals court foreclosed virtually any argument that creditors individually or collectively can sue shareholders on a constructive fraudulent transfer theory seeking recovery of payments received in a leveraged buyout for stock in a company that later files bankruptcy.

The case arose in the chapter 11 reorganization of newspaper publisher Tribune Co. and centered around Section 546(e), which provides that "the trustee may not" sue for recovery of a "settlement payment," unless the suit is brought under Section 548(a)(1)(A) for recovery of a fraudulent transfer within two years of bankruptcy made with actual intent to hinder, delay or defraud creditors.

The Second Circuit in substance was called on to decide whether there are any loopholes allowing creditors to sue for recovery of constructive fraudulent transfers when an LBO goes sour. The district court in the opinion on appeal had opened the door a crack, and a bankruptcy judge in the reorganization of Lyondell Chemical Co. had also found loopholes.

In Tribune's reorganization, the official creditors' committee was authorized to sue selling shareholders for allegedly receiving fraudulent transfers with "actual intent." Prosecuted after plan confirmation by a creditors' trust, that suit remains pending in bankruptcy court in Manhattan.

When the two-year statute of limitations was about to expire, Tribune's bankruptcy judge modified the automatic stay by allowing company retirees, along with pre-LBO unsecured bondholders, to sue selling shareholders using constructive fraudulent transfer theories. In modifying the stay, the bankruptcy judge did not rule on whether individual creditors had standing or whether a suit would be barred by Section 546(e)'s safe harbor. The individual creditors' suit ended up in district court in Manhattan, where the selling shareholders moved to dismiss.

Granting the motion to dismiss, the district court held that individual creditors lacked standing because the creditors' trust was simultaneously suing on fraudulent transfer grounds, albeit on a different theory. The judge also held that the safe harbor only bars suits by a trustee and does not preclude creditors from suing under state law.

Judge Winter reversed the district court on both scores, with dismissal still the result. He made short shrift of the district court's holding that the automatic stay deprived individual creditors of standing when the creditors' trust was suing to recover the same transfers as fraudulent transfers with "actual intent." The judge pointed out how the bankruptcy court on at least three occasions had modified the stay so individual creditors could sue.

Although he gave them back the right to sue, Judge Winter nonetheless knocked them out of the box under Section 546(e) on a theory of implied preemption. He said that implied preemption results when "state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."

He rejected the argument that only trustees are barred from suing by the safe harbor. Although the meaning of Section 546(e) is not "plain," Judge Winter said the creditors' arguments rely on "adhering to statutory language only when opportune and resolving various ambiguities in a way convenient to that theory." Ultimately, he said that the creditors' theory was in "outright conflict" with the section.

The creditors contended that fraudulent transfer claims revert to creditors if the trustee does not file suit within the two-year statute of limitations or if the automatic stay is lifted to allow suing. Judge Winter said that a reversion of fraudulent transfer claims "is not based on the language of the Code."

Although he conceded that Section 546(e) is ambiguous, Judge Winter said in his 53-page opinion that "unwinding settled securities transactions" would "seriously undermine" the markets. For reasons developed at length about the congressional policy shown in the safe harbor, the appeals court held that state law constructive fraudulent transfer claims are preempted.

The *Tribune* opinion cuts the ground from underneath a decision by the *Lyondell* bankruptcy judge in January 2014 holding that the safe harbor does not preclude fraudulent transfer suits based on state law, nor does it protect selling shareholders who ultimately received proceeds from allegedly fraudulent transfers.

Judge Winter's opinion contains a useful discussion of how to determine whether a statute's meaning is plain.

The opinion is *Note Holders v. Large Private Beneficial Owners (In re Tribune Co.)*, 818 F.3d 98 (2d Cir. March 29, 2016).

Reclamation

Judge Walrath disagrees with Judges Lifland and Gonzales on reclamation rights.

Delaware Judge Splits with New York by Upholding Reclamation Creditors' Rights

Companies or lenders hoping to defeat reclamation claims will find a more favorable forum in New York than in Delaware, in light of an Aug. 24 decision by Bankruptcy Judge Mary F. Walrath of Wilmington.

The case before Judge Walrath and the two cases in New York were similar. There was a pre-petition lender with a lien on inventory. A supplier gave the required notice of a reclamation claim under Section 546(c) pertaining to goods delivered within 45 days of bankruptcy. After filing, a loan from the debtor-in-possession lenders fully repaid the pre-petition secured claim. The DIP lenders were given a lien on all assets, including inventory.

In New York cases known as *Dairy Mart* and *Dana Corp.*, Bankruptcy Judges Arthur Gonzalez and Burton Lifland had held in 2003 and 2007, respectively, that the assets were effectively sold to repay pre-petition loans, in the process extinguishing reclamation rights. They also reasoned that the pre- and post-petition loans were in substance integrated transactions, giving lien rights to post-petition lenders ahead of reclamation rights.

Judge Walrath said she "respectfully disagrees" with the New York decisions. Instead, she followed the Sixth Circuit's *Phar-Mor* opinion from 2008, where the appeals court specifically rejected the two New York decisions.

The reclamation creditor's rights arose before the DIP lenders' security interest attached, according to Judge Walrath. She said it was "too much of a stretch" to believe that repayment of the pre-petition loan was a sale of the reclamation creditor's goods. The inventory in fact was not sold nor were proceeds paid to the lender, she said.

Similarly, she said the pre- and post-petition loans were not integrated transactions because they were made by two different lenders at two different times.

Judge Walrath recited how the DIP loan contained a provision stating that the new loan would be subject to liens perfected after bankruptcy under Section 546(b). It is unclear whether the result would have been the same were there no such provision in the DIP loan.

It is also unclear how much, if at all, Judge Walrath's decision was influenced by the realities of present-day reorganizations. When *Dairy Mart* and *Dana* were written, companies actually reorganized or attempted to do so. Thus, dropping a reclamation claim from administrative status to the level of a general unsecured claim would ease the burden on a debtor struggling to reorganize.

Today, large chapter 11 cases are often largely for the benefit of secured creditors aiming to buy the companies as cheaply as possible. In those cases today, lowering the status of reclamation claims mostly benefits the lenders. Thus, bankruptcy judges inclined to help debtors may now feel less need to do so since lenders today often are the chief beneficiaries.

The opinion is *In re Reichold Holdings US Inc.*, 14-12237 (Bankr. D. Del. Aug. 24, 2016).

Executory & Union Contracts

Bankrupt employers get a boost from the Third Circuit for negotiations with labor unions.

Expired Union Contract Can Be Rejected, Third Circuit Holds in Trump Chapter 11

Labor unions lost a major battle when the Third Circuit held that the bankruptcy court retains power to reject a labor contract even after it expired by its own terms.

The Third Circuit was the first appeals court to decide the issue. Lower courts are split. The debtor-friendly opinion on Jan. 15 is yet another reason for companies to file for reorganization in Delaware because the Philadelphia-based Third Circuit makes law for that district.

Rather than a tortured parsing of the statutory language to arrive at a result, the Third Circuit's opinion is a refreshing exercise in finding the best answer by focusing on the purpose of the law, since that Congress may not have had the precise facts in mind when adopting the statute.

The appeal arose from the reorganization of two casinos in Atlantic City, New Jersey, owned by Trump Entertainment Resorts Inc. Unite Here Local 54 wanted the Third Circuit to reverse an October 2014 decision by Bankruptcy Judge Kevin Gross in Delaware who sided with the casino operator and held there was power to reduce wages or benefits in expired contracts. Judge Gross allowed a direct appeal to the circuit.

In the *Hostess Brands Inc.* reorganization, Bankruptcy Judge Robert Drain from White Plains, New York, held in 2012 that power to terminate a collective bargaining agreement ends when the contract expires. Bankruptcy Judge Donald H. Steckroth from Newark, New Jersey, reached the same result as Judge Gross in a case called *710 Long Ridge Road*.

In her opinion deciding the Trump appeal in favor of the debtor, Circuit Judge Jane R. Roth said she would "not embark, as the parties do, on a hyper-technical parsing of the words and phrases that comprise Section 1113," the provisions in the Bankruptcy Code that govern rejection of labor contracts. Instead, she focused on the objectives of chapter 11 and the intent of Congress in adopting Section 1113 to overrule the Supreme Court's *Bildisco* decision.

The union argued that the expiration of a collective bargaining agreement meant there was no longer any contract in existence and thus nothing to reject. Were the union correct, the National Labor Relations Act would kick in, compelling the company to continue operating under the expired contract until NLRB declared an impasse in negotiations on a new contract.

Judge Roth noted that Section 1113 does not restrict its application to an executory contract. She went on to find that Congress intended "to incorporate expired collective bargaining agreements into the language of Section 1113."

She also held that allowing rejection of an expired contract is "consistent with the purpose of the Bankruptcy Code." Not allowing rejection, she said, "would impede that overriding goal" and "undercut the rehabilitative function of chapter 11."

Where bankruptcy courts can move quickly to modify union contracts when a company's survival is at stake, the NLRB can be slow to declare an impasse and thus allow an employer to impose new terms of employment. Judge Roth's opinion therefore gives a corporate debtor an important weapon for use against a labor union reluctant to grant concessions.

If expired contracts were beyond the reach of the bankruptcy court, some insolvent companies might be unable to survive the additional time required for NLRB proceedings and thus could be pressured into giving workers more than they might get under Section 1113.

Despite the Third Circuit's decisions, workers are not bereft of all power, because they can still determine whether a bankrupt company survives. Except for airline and railroad employees who cannot strike even if their wages are reduced, workers in other industries are at liberty to shut a company down if they dislike the wages imposed by the bankruptcy court.

Trump Entertainment filed for chapter 11 protection in Sept. 2014, seeking immediate relief from the labor contract at the 2,000-room Trump Taj Mahal. Its 906-room Trump Plaza had already closed. Carl Icahn, the dominant holder of $285.6 million in first-lien notes, aimed to buy the properties in exchange for debt, although only if labor and benefit costs were reduced.

The company confirmed a chapter 11 plan in March 2015. Consummation of the plan will not occur until rejection of the union contract is final.

The opinion is *In re Trump Entertaiment Resorts Inc.*, 810 F.3d 161 (3d. Cir. Jan. 15, 2016).

Compensation

***Artful drafting cannot evade* ASARCO**
to reimburse counsel for defense of fees.

Delaware Judge Categorically Bars All Counsel from Compensation for Defense of Fees

Bankruptcy Judge Mary F. Walrath in Delaware categorically barred lawyers from circumventing the Supreme Court's opinion in *Baker Botts LLP v. ASARCO LLC* by refusing to approve a retention application requiring the debtor to compensate committee professionals for successfully defending their fees.

In June, the Supreme Court held 6-3 in *ASARCO* that debtors' counsel in bankruptcy cases cannot be paid for successfully defending their fee requests. In Delaware, the reorganization of Boomerang Tube LLC became a test case to decide whether lawyers could sidestep *ASARCO* by incorporating the reimbursement of defense costs into a retention agreement approved up front by a bankruptcy judge.

In a footnote at the very end of her opinion, Judge Walrath in substance said that no form of artful drafting, even by the debtor's lawyers, will pass muster because using estate funds to pay fee defense costs "are not reasonable terms of employment of professionals."

Theoretically, the *Boomerang* decision does not bind the other Delaware bankruptcy judges. However, judges ordinarily discuss important decisions with their brothers and sisters on the bench in the same district. It would therefore be surprising if another Delaware bankruptcy judge reached a different result.

The proposed retention agreement between the Boomerang creditors' committee and its lawyers would have required the debtor to pay the cost of a successful defense of fees. Committee counsel contended that providing for defense costs as a term of employment under Section 328(a) was permissible because *ASARCO* only barred reimbursement in the allowance of fees under Section 330(a). Judge Walrath did not buy that theory and knocked down every other argument proffered by committee counsel.

She barred the use of Section 328 as a vehicle for paying defense costs because it, like Section 330(a), was not a "specific and explicit statute" overriding the American Rule against fee-shifting. Judge Walrath said that while Section 328 does not prohibit defense costs, "it simply does not authorize them."

Next, the committee contended that the engagement agreement fell under the so-called contract exception to the American Rule, allowing parties by contract to agree that the losing side pays everyone's lawyers. The argument was flawed, she said, because the debtor was not a party to the retention agreement. Even if the contract exception applied, Judge Walrath said she could not approve because fee-defense costs would not entail any services for the committee, only benefit the lawyers themselves.

Although *dicta*, Judge Walrath included a footnote at the very end of the opinion announcing she would not approve fee-shifting "in a retention agreement filed by any professional under Section 328(a) — including one retained by the debtor," because they would not be "reasonable terms of employment."

The opinion is *In re Boomerang Tube Inc.*, 548 B.R. 69 (Bankr. D. Del. Jan. 29, 2016).

Fraudulent Transfers

Rochelle's Daily Wire

Seventh Circuit won't immunize an LBO from fraudulent transfer just by using a bank conduit.

Circuits Split on Invoking Safe Harbor Whenever a Bank Serves as Conduit

The Seventh Circuit deepened an existing split among the courts of appeals by holding that a transfer through a financial institution as a conduit does not by itself invoke the safe harbor in Section 546(e) and immunize the entire transaction from avoidance as a fraudulent transfer.

The July 28 opinion by Chief Circuit Judge Diane P. Wood stands for the proposition that routing consideration for a leveraged buyout of a non-public company through a financial institution cannot preclude a fraudulent transfer attack if it turns out that the seller was rendered insolvent. It is less clear what the decision means for LBOs of public companies.

Judge Wood cited the Second, Third, Sixth, Eighth and Tenth Circuits as applying the safe harbor when a financial institution is nothing more than a conduit. She noted that the Eleventh Circuit "agrees with us."

Since Circuit Judge Richard A. Posner was on the panel along with Circuit Judge Ilana D. Rovner, the chances of persuading the court to hold rehearing *en banc* are remote.

If there is a petition for *certiorari*, the Supreme Court will have a chance to decide whether the safe harbors should be interpreted broadly, like the Second Circuit opinions in *Enron, Quebecor, Madoff* and, recently, *Tribune*.

The case in the Seventh Circuit was similar to a leveraged buyout. One company bought another, in part with money borrowed from a bank. Another bank served as escrow agent, holding the purchase price before passing it along to the seller.

Employing a constructive fraudulent transfer theory, the litigation trust established in the buyer's bankruptcy sued the 30% owner of the seller for $16.5 million, representing its share of the $55 million purchase price. Invoking Section 546(e), the district court dismissed the suit, holding that the safe harbor applied because the transfer was "made by or to" a financial institution.

The safe harbor precludes a trustee from attacking a transfer of a "settlement payment" that is "made by or to" a "financial institution," or a transfer "by or to" a "financial institution . . . in connection with a securities contract." Since the purchaser was buying stock, it was clear to

Judge Wood that the transfers were either a settlement payment or a payment in connection with a securities contract.

Judge Wood said it was therefore only necessary to decide whether the safe harbor protects transactions "simply [because they were] conducted through financial institutions." In typical Seventh Circuit fashion, the opinion is an exploration of the judges' understanding of the purpose of the statute, largely unaided by citation to authorities.

Although the Seventh Circuit previously had held that the safe harbor should be interpreted "broadly," that "does not mean that there are no limits," Judge Wood said. She declined to "interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution or other named entity as a conduit for funds." Instead, she said "it is the economic substance of the transaction that matters."

Judge Wood analyzed the purpose of the avoidance and safe harbor statutes because there are "multiple plausible interpretations" of the statutory language "made by or to." She also said the parenthetical "for the benefit of," added in 2006, "is also ambiguous."

Invoking the safe harbor simply because the parties used a bank conduit would "render any transfer non-avoidable unless it were done in cold hard cash, and that conflicts with Section 548(c)'s good faith exception," the opinion says. Instead, the safe harbor applies "only where the debtor incurred an actual obligation" to the financial institution that received the transfer.

Judge Wood also found support in the history of the safe harbor, which was designed to prevent a domino effect "'rippling through the securities industry.'" She said the safe harbor applies when the transferor or transferee is a financial institution. Tagging the selling shareholder with liability "will not trigger bankruptcies of any commodity or securities firm," the opinion says.

The opinion is *FTI Consulting Inc. v. Merit Management Group LP*, 15-3388 (7th Cir. July 28, 2016).

Fifth Circuit reluctantly lets a trade supplier off the hook for a fraudulent transfer from a Ponzi scheme.

Fifth Circuit and Texas Supreme Court Part Company on Ponzi Fraudulent Transfers

Despite an opinion by the Texas Supreme Court immunizing trade suppliers from fraudulent transfer claims for providing goods or services to a Ponzi scheme, the Fifth Circuit stood by its guns and continues to embrace a different theory of "value" to apply under Section 548 of the Bankruptcy Code.

The *per curiam* opinion on Aug. 22 arose from the $7 billion Ponzi scheme orchestrated by R. Allen Stanford, who is now serving a 110-year prison term. After the scheme fell apart, the receiver sued Golf Channel Inc. to recover $5.9 million that Sanford paid for advertising time targeting the channel's high-income audience as potential new investors.

The federal district judge ruled without holding a trial that Golf Channel provided "reasonably equivalent value," a valid defense to a fraudulent transfer claim. The district judge equated Golf Channel to an innocent trade creditor.

On appeal, the Fifth Circuit reversed in March 2015. While advertising "may have been quite valuable to the creditors of a legitimate business," the panel opinion by Circuit Judge Jennifer Walker Elrod held that "services to encourage investment in such a scheme do not provide value to the creditors" because they only prolong the fraud and increase innocent investors' losses.

The appeals court said the channel offered no evidence to show "how its services benefited Stanford's creditors." It only showed that its charges were at market rates, the circuit court said.

Having been ordered to repay the $5.9 million in advertising revenue, the channel filed a motion for rehearing *en banc*. In response, the panel withdrew its opinion and asked the Texas Supreme Court in June 2015 to advise whether the Texas Uniform Fraudulent Transfer Act requires proof of "reasonably equivalent value" from the perspective of creditors, or whether the defendant can defeat a fraudulent transfer claim by showing it provided goods or services at market value.

Texas' highest court answered the certified question in April when it said that "reasonably equivalent value" is provided under TUFTA when (1) services were fully provided under an arms'-length contract for "fair market value," (2) the consideration had "objective value" and (3) the exchange occurred in the ordinary course of the defendant's business. In the context of a

Ponzi scheme, the state court said that value is provided so long as the services would have been available to another buyer at market rates had they not been purchased by the Ponzi scheme.

From the perspective of a reasonable creditor, the Texas Supreme Court said the advertising services had value even if they depleted the Ponzi scheme's estate.

Bound by the Texas court's opinion on state law, the Fifth Circuit reversed its prior conclusion and upheld the district court's grant of summary judgment absolving Golf Channel of fraudulent transfer liability.

Observing that "TUFTA is unique among fraudulent transfer laws because it provides a specific market-value definition of 'reasonably equivalent value,'" the circuit's opinion on Aug. 22 served notice that the appeals court's prior decisions to the contrary under Section 548 of the Bankruptcy Code retain their "binding effect," as do Fifth Circuit opinions interpreting other states' fraudulent transfer laws.

The Fifth Circuit specifically reiterated its opinion from prior cases that the "primary consideration" is "the degree to which the transferor's net worth is preserved." The question is not whether the consideration had "objective value," but whether the exchange "conferred a tangible economic benefit on the debtor."

The opinion is *Janvey v. Golf Channel Inc.*, 13-11305 (5th Cir. Aug. 22, 2016).

Seventh Circuit upsets Illinois system
for collecting delinquent real estate taxes.

Sale of Delinquent Tax Certificates Leads to Fraudulent Transfer, Seventh Circuit Says

Selling a tax lien in Illinois results in a fraudulent transfer, according to the Seventh Circuit.

In addition, the Jan. 20 opinion by Circuit Judge David F. Hamilton is notable because it exposes the purchaser of the tax lien to the possibility of a judgment for the full market value of the property. Title insurers should take notice of the opinion and perhaps rethink the price for insuring a property purchased in an Illinois tax sale.

The opinion once again shows how the Seventh Circuit finds answers by divining "practical concerns about how to let federal bankruptcy law work well," rather than by teasing the result from the plain language of the statute.

The case involved a homeowner who didn't pay real estate taxes. Under the Illinois process for collecting delinquent taxes, a purchaser got a Certificate of Purchase by paying about $5,000, or slightly more than the outstanding taxes. The property owner had the right for a period of time to redeem the property by paying the taxes.

Four years later, the buyer sought and recorded a tax deed for the property. Six months after that, the purchaser sold the property for $50,000 to a third party in an arms'-length transaction. An appraiser said the property was worth $110,000.

Filing bankruptcy almost two years after the $5,000 sale, the debtor immediately sued the original buyer and the later purchaser.

Chief Bankruptcy Judge Bruce W. Black in Chicago ruled that the transfer was constructively fraudulent under Section 548(a)(1)(B) for lack of "reasonably equivalent value." The district court reversed, holding that compliance with state law granted immunity from a fraudulent transfer claim.

Lauding Judge Black's analysis, Circuit Judge Hamilton reversed the district court.

The case turned on the interpretation of the Supreme Court's 1994 opinion in *BFP v. Resolution Trust Corp.*, which generally held that a foreclosure sale in compliance with state law establishes "reasonably equivalent value" for fraudulent transfer purposes. Judge Hamilton spent a good part of the opinion explaining why *BFP* does not apply to Illinois tax lien sales.

He began by noting that the price paid by the initial purchaser is "usually nothing more than the sum of delinquent taxes." Since state law procedure does not involve an auction where bids will increase, Judge Hamilton said that a price between 3.8% and 8.8% of fair market value "is not reasonably equivalent value." That conclusion, he said, serves "the broader purposes of the Bankruptcy Code and its fraudulent transfer provisions."

The bankruptcy court awarded the debtor a $15,000 judgment against the initial purchaser, representing the amount the debtor scheduled as an exemption for the home. The bankruptcy judge dismissed the suit against the subsequent purchaser, who had paid $50,000. The circuit court upheld both.

The debtor was not entitled to a judgment for the value of the property, Judge Hamilton said, because there is no authority for the bankrupt to receive anything beyond the exemption.

The trustee had not joined the debtor in the suit. Significantly, the opinion implies that the trustee could have gotten a larger judgment, but Judge Hamilton does not hint at whether the trustee's award would have been the $50,000 purchase price or the $110,000 fair market value.

Another intriguing feature of the opinion is the treatment of the debtor's claim against the eventual third-party purchaser, who could raise the "good faith" defense as an immediate or mediate transferee from the initial transferee under Section 550(b)(2).

The opinion recites familiar law on good faith, saying that the subsequent transferee is "relieved of the responsibility to affirmatively monitor the initial transfer." For Section 550(b), there is a difference, Judge Hamilton said, between "good faith" and "without knowledge of the voidability of the transfer."

To tag a subsequent purchaser, there must be facts strongly suggesting the presence of other facts demonstrating fraud. "To be clear," Judge Hamilton said, there is no duty to investigate because "knowledge is a higher bar than inquiry notice." Therefore, the later buyer "need not conduct extensive research into the chain of title."

Although Judge Hamilton said there was no clear error in the bankruptcy court's good faith finding with respect to the later purchaser, his opinion suggests that another judge "on a similar record" could saddle a subsequent transferee with liability "simply because of the presence of a tax deed or because this was an unoccupied residence."

The opinion distinguishes opinions from the Fifth and Tenth Circuits because they involved state laws with different procedures calling for auctions in which the price could rise toward fair market value. Consequently, Judge Hamilton's opinion does not seem like a prime candidate for Supreme Court review.

The opinion is *Smith v. SIPI LLC (In re Smith)*, 15-1166 (7th Cir. Jan. 20, 2016).

Ninth Circuit joins two other circuits in extending* BFP *from foreclosures to tax sales.

Regularly Conducted Tax Sales Cannot Be Fraudulent Transfers, Ninth Circuit Holds

The Ninth Circuit joined the Fifth and Tenth by holding that a tax sale conducted in accordance with state law cannot be set aside as a fraudulent transfer for less than reasonably equivalent value.

A company owned real property but did not pay real estate taxes for years. The company filed a chapter 11 petition a month after the county sold the property in a tax sale. The newly minted debtor in possession immediately sued the county and the buyer to set aside the tax sale as a fraudulent transfer under the Bankruptcy Code and California law.

The bankruptcy court dismissed the complaint and was upheld by the Bankruptcy Appellate Panel. Circuit Judge Richard R. Clifton agreed with the BAP that the debtor could not state a claim for relief since there was no allegation that procedures followed in the tax sale failed to comply with state law.

In 1994, the Supreme Court held in *BFP v. Resolution Trust Corp.* that a regularly conducted foreclosure sale cannot result in a fraudulent transfer. Judge Clifton said that the "rationale and policy considerations" underlying *BFP* are "just as relevant in the California tax sale context."

Even though the price realized at the sale might be low, Judge Clifton upheld the lower courts and extended the holding in *BFP* to cover tax sales conducted in accordance with state law.

The complaint initially did not allege the amount of the inadequacy of the price. The debtor argued that the bankruptcy judge should have given leave to amend the complaint rather than dismiss the suit outright.

In his Sept. 8 opinion, Judge Clifton found no error in refusing to allow an amendment because the price was irrelevant since the complaint did not allege any procedural defect in the sale.

Judge Clifton distinguished several bankruptcy court decisions not extending *BFP* to tax sales because those cases entailed procedural deficiencies.

Judge Clifton added spice to the opinion by explaining that the debtor's name, Tracht Gut LLC, derives from the Yiddish phrase "Tracht gut, vet zein gut," meaning, "Think good, and it will be good."

The opinion is *Tracht Gut LLC v. Los Angeles Country Treasurer & Tax Collector (In re Tracht Gut LLC)*, 14-60007 (9th Cir. Sept. 8, 2016).

Rochelle's Daily Wire

Posner pens a gem warning banks about ignoring signs of fraud.

Seventh Circuit Reverses District Court Again, Lowering Standard for 'Inquiry Notice'

The Seventh Circuit is no safe haven for banks holding information that should lead them to suspect that their customers are up to no good.

Circuit Judge Richard A. Posner reversed a Chicago district judge a second time in the chapter 11 liquidation of Sentinel Management Group Inc., a money-manager that improperly used customers' supposedly segregated funds for its own trading. When the case returned to the Seventh Circuit in August 2013 on a motion for rehearing *en banc*, a different three-judge panel reversed, saying the trustee "should be able" to void the bank's lien and recover $312 million paid on a loan.

On remand, District Judge James B. Zagel did not take the hint. In an opinion in December 2014, he once again upheld the security interest, despite evidence that the bank suspected fraud was afoot. Reversing again in an opinion on Jan. 8, Judge Posner said that "the first panel's opinion may have been unduly deferential in remanding this issue rather than reversing outright."

The case is about "inquiry notice" and the consequences of ignoring red flags. In the Seventh Circuit, mere negligence in failing to inquire into possible fraud can result in the loss of a bank's security interest.

Sentinel provided cash-management services and promised customers that their funds would be segregated. Using a secured line of credit with a bank, Sentinel traded for its own account. Following market reverses in 2007, Sentinel began improperly taking customer funds to use as collateral for its own bank loan. After Sentinel filed under chapter 11 in August 2007, the bank had a secured claim for $312 million, collateralized by money that should have been segregated for customers. Sentinel sought a trustee four days after the chapter 11 filing.

Pursuant to Sentinel's chapter 11 plan, the trustee sued the bank in district court to void the security interest and subordinate the bank's debt. The trustee contended that transferring customer funds to the bank was a fraudulent transfer with "actual intent" under Section 548(a)(1)(A). The bank could retain the collateral if it was in "good faith" as required by Section 548(c), Judge Posner said.

After a lengthy trial, District Judge Zagel exonerated the bank, saying that an attempt to "stay in business" by stealing from one creditor to pay another represented a motive not constituting intent to defraud. Writing for the appeals court on the first appeal, Circuit Judge John D. Tinder said that "someone who has the best intentions can still possess actual intent to defraud."

Sending the case back to the district court on remand, Judge Tinder said the bank could raise defenses, such as having made the loan to Sentinel in good faith. He also said the so-called good-faith defense is unavailable to someone with "sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency."

Judge Tinder went on to add that the bank "will have a very difficult time proving that it was not on inquiry notice of Sentinel's possible insolvency."

On remand, District Judge Zagel stuck by his guns and let the bank off the hook a second time. When the case came up again, Circuit Judge Posner said that Judge Zagel misunderstood "the concept of inquiry notice." Establishing an objective standard, he said that inquiry notice "is not knowledge of fraud or other wrongdoing but merely knowledge that would lead a reasonable, law-abiding person to inquire further."

The damning evidence was a banker's message to a subordinate asking whether the bank had rights to the collateral and how Sentinel could post $300 million when it only had $20 million in capital. The banker got an evasive answer from the underling, and the inquiry went no further.

That "puzzlement," according to Judge Posner, was enough to put the bank on inquiry notice. He went on to say that "knowing or turning a blind eye" to misconduct would make the bank guilty of fraud "but was not required to establish inquiry notice."

Although the bank lost on the fraudulent transfer question, thus voiding its security interest, the second question on appeal dealt with equitable subordination, which the bank won. On that issue, Judge Posner upheld the district court, allowing the bank to retain an unsecured claim for $312 million.

Judge Posner said that reason to suspect wrongdoing is negligent, but negligence is not enough for equitable subordination, which requires conduct that is egregious or tantamount to fraud.

The opinion rejected two other defenses proffered by the bank. Judge Posner said that Section 550(b)(1) does not apply because voiding a lien is not the same as recovering an asset. He also barred the use of Section 550(d) because there was no double recovery by the trustee.

The Sentinel appeals hint at intrigue behind the scenes in the Seventh Circuit. The first time the case came up on appeal, the original three-judge panel upheld Judge Zagel in August 2012. After the trustee filed a motion for rehearing *en banc*, the three judges withdrew their first opinion, reversed, and remanded in August 2013, as described above. One wonders whether other judges on the circuit suggested to the original panel that they should reconsider to avoid a reversal *en banc*.

The Jan. 8 opinion is noteworthy because Circuit Judge Frank Easterbrook was on the panel. Judges Posner and Easterbrook often author the Seventh Circuit's most important bankruptcy opinions. Only Circuit Judge Ilana D. Rovner was on both panels.

The opinion is *Grede v. Bank of New York Mellon Corp.*, 809 F.3d 958 (7th Cir. Jan. 8, 2016).

Later bankruptcy is no proof of prior inadequate capitalization.

Subjective Test Without Hindsight Employed to Determine Adequate Capitalization

In evaluating a constructively fraudulent transfer claim, the Third Circuit held that a debtor's subjective belief is pivotal in deciding whether the debtor had sufficient capital.

The appeal arose in the aftermath of the confirmation of SemGroup LLP's chapter 11 plan. A creditors' trust established by the plan sued for the recovery of distributions to shareholders made within two years of bankruptcy. Upheld in district court, the bankruptcy court conducted a trial and found that the creditors' trustee did not prove that SemGroup had inadequate capital at the time of the distributions.

The Third Circuit affirmed in a non-precedential opinion on April 28 written by Circuit Judge Thomas I. Vanaskie.

The trustee conceded that the company had adequate capital if it could borrow under the bank credit agreement. To overcome the fact that the company in fact borrowed after the distributions were made, the trustee argued that SemGroup would have been unable to borrow had the banks known about the company's "allegedly improper trading strategy."

The bankruptcy and district courts declined to speculate about what the banks might have done had they known about the trading. Agreeing, Judge Vanaskie said, "Absent the bias of hindsight, it simply cannot be said that SemGroup was likely to be denied access to a credit facility," given the banks' alternatives such as restructuring the loan or requiring the sale of assets. On the facts shown at trial, it was significant, Judge Vanaskie said, that the trading strategy was not cited by the banks when they declared a default later.

The opinion is perhaps most important for its focus on the borrower's subjective belief. The opinion said that the trustee did not "show that SemGroup could reasonably foresee either that its trading strategy would fail or that the bank group would declare a default based upon that trading strategy."

The opinion mentions several times that the outcome might have been different were there fraud or deception. "The trustee presented no evidence that SemGroup tried to disguise its trading strategy from the bank group or acted deceptively," the opinion says.

The opinion is *In re SemCrude LP*, 14-4356, 2016 BL 135006 (3d Cir. April 28, 2016).

ROCHELLE'S DAILY WIRE

Former Bankruptcy Judge Gerber reversed in* Lyondell *for being too strict, then for being too lenient.

New York District Judge Lays Down Lenient Standard for Imputing Fraudulent Intent

Reversing the bankruptcy court, a district judge in New York laid down a relatively easy pleading standard for a fraudulent transfer with "actual intent" when the plaintiff must impute an executive's knowledge of fraud to the company itself.

The opinion on July 27 by District Judge Denise Cote involved the Lyondell Chemical Co. bankruptcy that began in 2009 and led to confirmation of a chapter 11 plan the next year. The plan created several trusts. One filed suit alleging that Lyondell's pre-bankruptcy leveraged buyout was a fraudulent transfer with "actual intent" under Section 548(a)(1)(A).

The complaint alleged that Lyondell's chief executive knowingly gave inflated financial projections both to the board and to the prospective buyer. Based on those projections, the complaint alleges that the buyer eventually purchased Lyondell in an LBO where the company took on $21 billion in secured debt, which soon led to bankruptcy.

The plaintiff alleged that the CEO concocted false projections because he got $100 million from the LBO, much of that from Lyondell stock and options that he owned.

Former Bankruptcy Judge Robert E. Gerber, who retired in January, dismissed the suit last year, holding that the chief executive's alleged knowledge of fraud could not be imputed to the company because Lyondell had a "functioning board" and the plaintiffs did not allege that the CEO controlled the board.

Judge Cote reversed and reinstated the suit, holding that Judge Gerber's formulation of imputation did not square with Delaware law. She said that Delaware courts follow a "general rule of imputation" by holding "a corporation liable for the acts and knowledge of its agents 'even when the agent acts fraudulently.'"

Therefore, she said, the CEO's knowledge and intent could be imputed to the company, because requiring control of the board does "not appear to have any basis in Delaware agency law."

Having imputed the CEO's knowledge and intent to the company itself, it was also necessary for Judge Cote to decide whether the alleged facts made out a claim for a fraudulent transfer with "actual intent." Judge Gerber had not reached that issue because he held that the CEO's knowledge could not be imputed in the first place.

Since the complaint alleged several "badges of fraud," Judge Cote reinstated the complaint, ruling that the plaintiff stated a claim under Section 548(a)(1)(A).

In Judge Cote's decision, Judge Gerber was reversed for being too strict on the plaintiff. In his *Lyondell* decision in January 2014 holding that the Section 546(e) safe harbor does not bar suits based on state law, he was effectively reversed by the Second Circuit's *Tribune* decision in March for being too lenient. Not bound by Second Circuit authority, Bankruptcy Judge Kevin Gross in Delaware ruled in June that Judge Gerber got it right on the safe harbor issue. To read ABI's discussion of the *Tribune* decision, click here. To read about Judge Gross' decision, click here.

The opinion is *Weisfelner v. Hoffman (In re Lyondell Chemical Co.)*, 16-518 (S.D.N.Y. July 27, 2016).

ROCHELLE'S DAILY WIRE

Sixth Circuit revives lawsuit against lender that allegedly aided Ponzi scheme.

Sixth Circuit Splits with the Second over the *Wagoner* Rule on Standing

The Sixth Circuit declined to follow the Second Circuit's 1991 decision in *Shearson Lehman Hutton, Inc. v. Wagoner* and raised the odds that a trustee can mount a successful suit on behalf of Ponzi scheme victims by announcing an exception to the *in pari delicto* doctrine.

The Cincinnati appeals court's decision runs counter to opinions by the Second Circuit and New York district courts that barred lawsuits by the trustee in the Bernard Madoff Ponzi scheme.

The Ponzi Scheme

The case involved a prototypical fraud where two men purchased a legitimate business in 2002 that for years had sold notes to investors to finance a factoring business. Immediately after the sale, the new owners caused the company to begin issuing vastly larger amounts of notes to generate funds that they loaned to their other businesses and ultimately used to finance their elaborate lifestyles.

According to the Aug. 23 opinion by Circuit Judge Andre M. Davis, the buyers turned the company into a typical Ponzi scheme, by selling new notes to pay off prior investors. After the FBI raided the company's office in 2009 and exposed the fraud, investors initiated an involuntary chapter 7 case in early 2010. By that time, the related companies owed \$233 million to the bankrupt company. Judge Davis said that the related companies never made any significant payments on their loans. Innocent noteholders had claims for \$208 million.

The Trustee's Suit

The target of the trustee's lawsuit was a sophisticated lender that helped finance the acquisition with a secured loan in 2002, along with a co-lender. In 2004, the lender refinanced the 2002 loan, in the process paying off the co-lender, which wanted to exit the credit. Later wanting to exit the credit itself, the lender recovered the entire \$17 million it was owed with proceeds from a sale of assets in 2007.

Just before the two-year window was about to close under Section 108(a), the trustee filed suit in bankruptcy court in early 2012 alleging that the lender knew about or was willfully blind to the fraud. The trustee made claims for aiding and abetting, conspiracy, and actual and constructive fraudulent transfers under the Ohio Uniform Fraudulent Transfer Act, seeking to recover, among other things, the entire $316 million the lender was paid in connection with the loan. The district court withdrew the reference but referred the lender's motion to dismiss to the bankruptcy court for a report and recommendation.

Although the bankruptcy judge recommended denying the motion, the district court dismissed the suit, prompting the trustee's successful appeal to the Sixth Circuit.

Don't Find Disputed Facts on a Motion to Dismiss

The trustee alleged that the 2004 loan and subsequent payments were actual or constructive fraudulent transfers. The district court dismissed the suit, in part relying on the notion that the original lien from 2002 remained in effect and thus provided adequate consideration for the later payments on the refinanced loan.

The circuit court in substance concluded that the district court erred by making findings of fact on a motion to dismiss based on disputed facts. Interpreting the allegations in a light most favorable to the trustee, the Sixth Circuit said that the complaint at least raised an ambiguity about the parties' intent in 2004 to effect a novation and extinguish the 2002 security interest, replacing it with a new loan. With a new loan in place, the appeals court said the complaint made out plausible fraudulent transfer claims that the 2004 refinancing and subsequent transactions were "undertaken in an effort to perpetuate a Ponzi scheme."

The Statute of Limitations Defense

Alternatively, the lender argued that the complaint was time barred because the statute of limitations in Ohio for a fraudulent transfer is four years after the transfer or one year after it "was or reasonably could have been discovered."

The appeals court agreed that the constructive fraud claim was barred by the statute of limitations. On the actual fraud claim, the Ohio Supreme Court has not decided whether discovery occurs when the transfer is discovered or when the transfer's fraudulent nature is discoverable.

The Sixth Circuit made a so-called *Erie* guess and decided that Ohio's highest court would focus on discovery of the fraudulent nature of the transactions. Because the plaintiff would not have known about the fraud until the FBI's raid in 2009, the suit was timely since bankruptcy occurred in 2010.

Judge Davis' opinion is significant for the rationale behind the *Erie* guess. He said that the purpose of the UFTA is to "discourage fraud" and provide recovery for defrauded creditors. Running the statute from discovery of the transaction, not the disclosure of its fraudulent nature, he said, would be "directly at odds with the animating purpose of the UFTA." He said that timing the discovery period from knowledge of the transaction would reward those who conceal fraud and injure creditors whose claims would "lapse before even becoming aware of the damage."

Sixth Circuit Won't Follow *Wagoner*

Next, the lender argued that the trustee lacked standing to bring the civil conspiracy claim, relying on the Second Circuit's *Wagoner* decision. *Wagoner* stands for the proposition that the trustee cannot sue on behalf of the company because the company was a participant in the fraud.

Judge Davis declined to follow *Wagner* because it "appears to conflate the affirmative defense of *in pari delicto* with the issue of standing." Citing the Eighth, Eleventh and Third Circuits as being in disagreement with *Wagoner*, he held that the trustee had standing for his civil conspiracy claim.

Exceptions to *In Pari Delicto*

Although *in pari delicto* does not deprive the trustee of standing, the doctrine, Judge Davis said, "is likely" to bar the civil conspiracy claim, absent an exception that allows the suit to survive. The trustee thus argued that the innocent insider exception permits the suit to stand.

The Sixth Circuit had to make another *Erie* guess, this time deciding whether the Ohio Supreme Court would recognize the innocent insider exception. Courts that recognize the exception do not apply *in pari delicto* to dismiss a suit when there is an innocent person inside the company with power to stop the fraud if he or she knew it was happening.

At that juncture, the lender argued that the complaint made no allegations showing the existence of the required innocent insider. On that issue, the Sixth Circuit again reversed the district court, holding that a plaintiff is not required to plead facts in a complaint to defeat an affirmative defense.

Adverse Domination

The appeals courts made a third *Erie* guess, this time on the question of whether the doctrine of adverse domination tolls the statute of limitations for civil conspiracy. According to Judge Davis, the Sixth Circuit issued a decision early this year that appeared to say that Ohio would not adopt the doctrine.

That decision, Judge Davis said, was not a precedential opinion and thus not binding. He therefore went on to predict that the Ohio Supreme Court would adopt the adverse domination doctrine to toll the statute of limitations.

The opinion is *Bash v. Textron Financial Corp. (In re Fair Finance Co.)*, 15-3854 (6th Cir. Aug. 23 2016).

Preferences, Claims & 'Flip Clauses'

ROCHELLE'S DAILY WIRE

Seventh Circuit lauds Judge Lane's
Quebecor World *preference opinion.*

Seventh Circuit Broadens 'Ordinary Course' Defense to Benefit Suppliers

The Seventh Circuit, reversing the bankruptcy court, interpreted the so-called ordinary course defense to benefit suppliers by helping them fend off preference suits.

According to the June 10 opinion by Circuit Judge Diane S. Sykes, the bankruptcy court should have allowed the defense for payments in the preference period that fell within the range representing 88% of payments before the onset of financial difficulties.

In a chapter 11 case, the creditors' committee sued a supplier for $587,000 in preferences on 23 invoices paid within 90 days of bankruptcy. The bankruptcy judge held that the creditor received about $306,000 in preferences after applying the ordinary course defense in Section 547(c)(2)(A), which absolves a creditor from liability for receipt of a preference made in the ordinary course of business or made according to ordinary business terms. Subtracting some $63,000 in new value defenses, the bankruptcy judge entered judgment for about $243,000 against the creditor.

When Judge Sykes got through explaining why the bankruptcy judge misapplied the ordinary course defense, the creditor had no liability whatsoever.

The "subjective ordinary course defense," according to Judge Sykes, inquires as to whether payments to the creditor during the preference period "are consistent with the parties' practice *before* the preference period." The court therefore must establish a "baseline" to "reflect the payment practices that the companies established before the onset of any financial difficulties."

To determine the baseline, Judge Sykes said that courts either use the "average lateness method" or the "total-range method." The average approach uses the average invoice age in the historical period, while the total-range method "uses the minimum and maximum invoice ages during the historical period to define an acceptable range of payments." She said it was not error for the bankruptcy judge to have used the average age method.

To establish a baseline for payments before the onset of financial trouble, the bankruptcy judge calculated the average invoice age as 22 days and added six days to both ends. Consequently, payments were not eligible for the ordinary course defense unless they were made within 16 to 28 days, according to the bankruptcy judge.

Judges Sykes said the bankruptcy court erred in applying the average age method. She said it was "clear error" to limit the defense to six days on either side of the average, because that spread would cover only 64% of payments in the historical period. Significantly, she said the bankruptcy judge gave "no explanation" for the narrow range.

By adding two days to the bankruptcy court's spread, thus making the defense applicable to payments within 14 and 30 days, 88% of payments in the historical period would have been immunized. Judge Sykes thus concluded that the 16- to 28-day window was "not only excessively narrow but also arbitrary."

Even the 14- to 30-day window was not inflexible. Judge Sykes held that payments "just outside" of that time frame are also covered by the defense. As a result, she made the defense applicable to a payment in 31 days.

In conclusion, Judge Sykes held that the defense did not apply only to payments 37 and 38 days after the invoices were issued, making the creditor liable for about $61,000. Since the creditor had some $63,000 in new value defenses, the creditor walked away from the appeal with no liability at all.

Bankruptcy Judge Sean H. Lane of Manhattan came off looking good. Judge Sykes approvingly cited his *Quebecor World* opinion several times for his approach to the ordinary course defense.

The opinion is *Jason Foods Inc. v. Unsecured Creditors' Committee*, 2016 WL 3213096 (7th Cir. June 10, 2016).

Debtor-friendly opinion validates strategy for cramming down on secured lender.

Claim Buyer Doesn't Acquire Seller's Insider Status, Ninth Circuit Holds

Over a cogent dissent, the Ninth Circuit approved a strategy for cramming down a plan by manufacturing an accepting creditor class eligible to vote "yes."

The corporate debtor in this case had a problem: There were only two creditors. One was a bank with a $10 million secured claim. The other was the debtor's general partner, which had a $2.8 million unsecured claim.

As an insider, the general partner's vote in favor of the plan could not be counted under Section 1129(a)(10). For lack of an accepting class, the plan could not have been confirmed and crammed down, because the bank opposed the plan.

To solve the problem, the general partner sold its claim for $5,000 to a close friend of one of the owners of the general partner. The plan called for a $30,000 distribution on the unsecured claim.

The bankruptcy judge ruled that the buyer automatically became an insider upon purchasing the claim. The Bankruptcy Appellate Panel reversed and was upheld in a 2-1 opinion, with Circuit Judge N. Randy Smith writing for the majority.

The case turned on the definition of "insider" contained in Section 101(31), which names several types of people, known as statutory insiders, who are automatically insiders. By the definition's use of the word *including*, Judge Smith said that others become "non-statutory insiders" if they have "a sufficiently close relationship with the debtor to fall within the definition."

In the principal holding of the case, all three judges, including the dissenter, agreed that a "person does not become a statutory insider solely by acquiring a claim from a statutory insider." Judge Smith said that the Code distinguishes between the status of a claim and the status of a creditor. Insider status, he said, pertains only to the claimant.

Consequently, Judge Smith said that status as an insider entails a "factual inquiry that must be conducted on a case-by-case basis." To become an insider, a claim buyer "must have a close relationship with the debtor and negotiate the relevant transaction at less than arm's length," he said.

If a buyer were automatically an insider, Judge Smith said that the purchaser would be foreclosed from voting even if the transaction was negotiated at arm's length.

The bankruptcy judge had determined that the buyer was not an insider based on his conduct and relationship with the debtor and its owners. Since the buyer as a matter of law did not become an insider by purchasing the insider's claim, the majority on the circuit court upheld the appellate panel because the bankruptcy judge's findings of fact on insider status were not clearly erroneous.

Circuit Judge Richard R. Clifton dissented in part. To him, it was "clear" that the buyer should have been deemed an insider. In his view of the facts, the sale was not negotiated at arm's length.

The case had an interesting twist that is likely to arise in similar situations. During pretrial discovery, the bank offered to purchase the claim from the buyer for $50,000 and later raised the offer to $60,000. The offer was not accepted and eventually lapsed.

Neither the appellate panel nor the circuit judges bought the bank's argument that refusing the offer showed bad faith.

The opinion is *U.S. Bank NA v. The Village at Lakeridge LLC (In re The Village at Lakeridge LLC)*, 13-60038, 634 Fed.Appx. 619 (9th Cir. Feb. 8, 2016); petition for certiorari filed June 13; views of Solicitor General sought Oct. 3.

Judge Chapman rejects former Judge Peck's opinion invalidating flip clauses in swaps.

Two New York Judges Disagree on Anti-*Ipso Facto* Law and Lehman Flip Clauses

Despite the anti-*ipso facto* clause in the Bankruptcy Code, a properly drafted flip clause can be enforceable when terminating a swap agreement even after bankruptcy, according to an opinion by Bankruptcy Judge Shelley C. Chapman, who disagrees with former Bankruptcy Judge James M. Peck from whom she inherited the Lehman Brothers bankruptcy.

Even if there were a violation of the *ipso facto* clause, Judge Chapman ruled in her 55-page opinion on June 28 that a flip clause is enforceable under the exception to the automatic stay in Section 560 of the Bankruptcy Code, again disagreeing with decisions Judge Peck handed down before he retired from the bench in 2014.

After former Judge Peck's first decision on the issue in 2010, it looked as though flip clauses were unenforceable in bankruptcy. Resulting in part from intervening Second Circuit authorities, the tables turned 180 degrees, making flip clauses now generally valid, assuming Judge Chapman's analysis holds up on appeal.

Lehman and Flip Clauses

On filing for chapter 11 protection in September 2008, Lehman Brothers Holdings Inc. and its subsidiaries had thousands of swaps in their portfolios, some including so-called flip clauses. The flip provisions came into play when Lehman was "in the money" at the outset of bankruptcy and stood to recover from termination of the swaps.

Without going into detail about the alternative ways in which flip clauses were drafted, suffice it to say that the provisions provided that collateral ordinarily would go first to Lehman subsidiary Lehman Brothers Special Financing Inc. (known as LBSF) as the swap counterparty in an ordinary maturity or termination.

On the other hand, if the Lehman parent or LBSF were to file bankruptcy, thus creating an event of default, the swap counterparty could terminate the swap prematurely. In those situations where Lehman or LBSF was the defaulting party, the flip clause would kick in and send the collateral proceeds first to noteholders. Since noteholders were never paid in full, LBSF got nothing when the flip clauses were invoked.

In 2010, Lehman sued 250 defendants in bankruptcy court, contending that the flip clauses violated anti-*ipso facto* provisions in Sections 365(e)(1), 541(c)(1)(B) and 363(l) of the Bankruptcy Code. Lehman contended that flip clauses were invalid because those subsections say that contractual provisions are unenforceable if they become effective on insolvency or bankruptcy.

In different adversary proceedings involving different counterparties, Judge Peck wrote decisions in 2010 and 2011 where he agreed with Lehman and concluded that flip clauses violated the anti-*ipso facto* statutes. He also decided that § 560 did not apply. Neither of those decisions went up on appeal, and no other court in the meantime has pronounced on the validity of flip clauses in bankruptcy.

When Judge Peck left the bench, Judge Chapman took over the Lehman bankruptcy, including the adversary proceeding that gave rise to her decision in late June.

Judge Chapman's Rationale

The defendants filed motions to dismiss, which Judge Chapman granted except for a pair of transactions with different facts where the defendants had not filed Rule 12(b)(6) motions. Judge Chapman disagreed with Judge Peck because she interpreted the Bankruptcy Code differently.

Among the defendants, there were important factual differences, allowing Judge Chapman more easily to dismiss as to some of them. The factual distinctions arose because the Lehman parent filed bankruptcy 18 days before LBSF. In all the transactions, LBSF was the swap party, and the Lehman parent was the guarantor of LBSF's obligations. The first bankruptcy filing by the Lehman parent was a default giving the right to terminate the swaps with LBSF.

Some of the defendants terminated the swaps after the parent's bankruptcy but before LBSF's, and in others, the termination did not occur until after LBSF's own chapter 11 filing. For Judge Peck, timing was important. In his 2010 decision, a termination after LBSF's bankruptcy made it easier for him to rule that invoking the flip clause violated anti-*ipso facto* law. In *dicta*, however, Judge Peck said the result would have been the same even for terminations that came before the LBSF bankruptcy.

Analyzing § 560, which permits termination of swaps, Judge Chapman said it did not matter whether termination was before or after LBSF's bankruptcy.

Judge Chapman divided the cases into two groups. Depending on how the swaps were written, one set of cases, the majority, did not even involve flip clauses, she said.

In what she called Type I cases, the swaps were written so LBSF would get the collateral on termination. The Type I agreements contained flip provisions switching the priority in collateral distribution to the counterparties if Lehman were the defaulting party.

Type II agreements contained no flip clauses, Judge Chapman said. Instead of changing the priority of distribution, Type II swaps had two different distribution regimes, one when Lehman filed bankruptcy and the other when Lehman did not default.

According to Judge Chapman, Type II agreements had no flip clauses because there was no modification of Lehman's rights, just the application of the appropriate distribution regime. Consequently, counterparties with Type II agreements could terminate swaps under § 560 without running afoul of anti-*ipso facto* provisions because there were no flip clauses in the first place. In other words, adroit drafting could result in a different result without changing the substance of the underlying agreements.

Even if Type II agreements were interpreted as having flip clauses, Judge Chapman next held that the flip clauses were enforceable under § 560 if termination took place before the LBSF bankruptcy, even if distribution of proceeds occurred after LBSF's bankruptcy. She held that the language in §§ 365(e)(1), 541(c)(1)(B) and 363(l) only bars modifications of debtors' rights for actions taking place after bankruptcy.

Debunking the 'Single Event' Theory

Judge Peck invalidated terminations and distributions that occurred before LBSF's bankruptcy using what he called the "single event" theory. He focused, for instance, on the language in § 365(e)(1)(B) which bars modification of rights based on commencement of "a" bankruptcy case, not "the" bankruptcy of "the" debtor invoking the anti-*ipso facto* laws.

Judge Chapman disagreed. She said the statutory references to "the case" can refer "only to the case of the debtor who is a party to the relevant executory contract."

Consequently, Judge Chapman declined to adopt the single event theory and exercised discretion not to follow Judge Peck's decisions as law of the case.

Section 560 Validates Flip Clauses in Any Event

Even if he had been correct up to this point, Judge Chapman again disagreed with Judge Peck and still validated the flip clauses under § 560. She said that Judge Peck's narrow interpretations of § 560 preceded decisions from the Second Circuit giving safe harbors "broad and literal interpretation." Among the decisions she cited was *Tribune*, decided in March. To read ABI's discussion of *Tribune*, click here.

Lehman argued that § 560 does not apply to flip clauses because that section pertains only to "liquidation, termination, or acceleration" of swap agreements. In Lehman's view, altering the priority of distribution was neither liquidation, termination, nor acceleration.

Given how the Second Circuit believes that safe harbors must be interpreted broadly, Judge Chapman declined to give § 560 a narrow interpretation.

Where Do We Go Next?

With the amount of money involved, Lehman is unlikely to roll over and play dead following Judge Chapman's decision. However, the time for appeal has not arrived because dismissal orders are yet to be entered.

If there is an appeal, Lehman can argue that Judge Chapman's decision elevates form over substance by holding that adroit drafting can turn a flip clause into something else.

Even victory on that issue will not carry the day unless Lehman can turn the tide in the Second Circuit by convincing the appeals court to reverse course and narrowly construe a safe harbor.

Very possibly, Lehman's fate is sealed in the Second Circuit. To succeed, Lehman may need another appeals court to create a conflict of circuits on the safe harbors, so the Supreme Court can take up the issue.

The opinion is *Lehman Brothers Special Financing Inc. v. Bank of America NA (In re Lehman Brothers Holdings Inc.)*, 10-ap-3547 (Bankr. S.D.N.Y. June 28, 2016).

Automatic disallowance under Section 502(d) held not applicable to administrative claims.

Preference May Be Offset by an Unpaid Administrative Claim, Judge Carey Rules

Ruling on an important issue in cases of administrative insolvency, Bankruptcy Judge Kevin J. Carey of Delaware concluded that a supplier can offset an unpaid administrative claim against preference liability.

Were the decision otherwise, a supplier in a failed reorganization would be required to pay a preference judgment in full without receiving payment on an allowed administrative claim.

From one point of view, the decision allows unequal treatment among holders of administrative claims. On the other hand, disallowing setoff would discourage a supplier from shipping goods after a chapter 11 filing if the supplier has preference exposure.

The case involved a failed chapter 11 reorganization. The supplier had almost $14 million in preference exposure. After filing, the supplier provided another $2.6 million in goods but was not paid. On motion, the bankruptcy court granted the supplier an allowed $2.6 million administrative claim that was not paid because the debtor was administratively insolvent.

The creditors' committee sued the supplier for preferences. The supplier denied liability and counterclaimed for the right to offset the unpaid administrative claim against preference liability. The committee filed a motion to dismiss the supplier's setoff counterclaim. Judge Carey denied the motion in his opinion on July 25, thus allowing setoff.

Judge Carey said that setoff is permitted only when "'opposing obligations arise on the same side of the . . . bankruptcy petition date.'" Setoff is allowed, he said, because a preference claim does not exist before the filing date.

Judge Carey also rejected the committee's argument that Section 502(d) prohibits setoff until the preference is paid in full. That section disallows "any claim" until the creditor pays its liability arising from an avoidance action.

"By its terms," Section 502(d) does not cover administrative expense claims, Judge Carey said. He cited cases holding that administrative claims are given "special treatment" and are not subject to Section 502(d).

The opinion is *Official Committee v. Tyson Foods LLC (In re Quantum Foods LLC)*, 15-50254 (Bankr. D. Del. July 25, 2016).

BAPs, Subordination & Dismissal

BAPs weren't created by Congress,
Ninth Circuit holds over vigorous dissent.

BAPs Lack Jurisdiction to Issue *Mandamus* Writs, Ninth Circuit Majority Holds

[The Ninth Circuit granted rehearing *en banc* in this case. Consequently, the panel opinion discussed below was withdrawn. The *en banc* decision expected next year will resolve or raise significant constitutional issues regarding Bankruptcy Appellate Panels.]

Over a vigorous dissent, the Ninth Circuit held that Bankruptcy Appellate Panels were not "established by an Act of Congress" and thus lack jurisdiction to issue writs of *mandamus* under the All Writs Act contained in 28 U.S.C. Section 1651(a).

Circuit Judge Jay S. Bybee "emphatically" dissented. Although he agreed with the judgment, Judge Bybee "vigorously" disagreed "with everything else" in the majority's opinion written by Circuit Judge J. Clifford Wallace.

The appeal arose from a home foreclosure 15 years ago. *Pro se*, the homeowner filed multiple, uniformly unsuccessful proceedings in bankruptcy court and on appeal, alleging that foreclosure violated the automatic stay. His most recent loss was in 2012, when the Ninth Circuit's Bankruptcy Appellate Panel denied his *mandamus* petition after the bankruptcy court held there was no jurisdiction to adjudicate an alleged stay violation long after the bankruptcy case had been closed.

Without briefing from the parties or seeking *amicus* briefs on the issue, the Ninth Circuit *sua sponte* held in Judge Wallace's opinion on March 25 that BAPs were not "established by an Act of Congress." Instead, the majority concluded that BAPs were created at the "discretion" of the "judicial council of each circuit" under 28 U.S.C. Section 158(b)(1).

The majority said that BAPs are created "on a temporary basis" and have "none of the permanency of a court." Rather than having been created by Congress, they result from the "independent action" of a "third party," namely, the judicial councils in each circuit, and thus lack jurisdiction to entertain *mandamus* petitions.

Dissenting, Judge Bybee said that BAPs are "plainly a court established by an Act of Congress." He would have reached the merits and upheld dismissal of the *mandamus* petition on several grounds, such as *res judicata*, since the debtor had lost the same argument several times before.

Judge Bybee said the majority altered the All Writs Act by requiring that courts be "directly" created by Congress as a condition to having jurisdiction for issuing writs. That conclusion, he said, "grinds an axe with which to cut the BAP off at the knees."

The majority's opinion, he said, "raises serious constitutional concerns with the separation of powers" and "is going to cause us major constitutional headaches."

In his view, BAPs are not "some mere tribunal or administrative adjunct." They are, he said, an "alternative to federal district courts" and are "treated by statutes as equal in authority to the district court." He pointed out how three circuits have held that bankruptcy courts themselves can issue writs of *mandamus*. The majority, he said, "left the BAP out in the cold."

By holding that BAPs are established by a circuit's judicial councils, Judge Bybee said the majority raised a "troubling question: Can Congress delegate its power to create courts to the judicial branch?" Judge Bybee said he was "deeply skeptical of the constitutionality of such an arrangement."

In view of the Ninth Circuit's 1992 holding in *Perroton v. Gray*, "It is bizarre that a circuit that is the most supportive of BAPs is the most restrictive of its powers," said Prof. Bruce A. Markell of the Northwestern Univ. Pritzker School of Law. In an e-mail, Prof. Markell explained how the Ninth Circuit BAP had to perform "mental gymnastics" whenever a litigant would ask for *in forma pauperis* status. The BAP was forced to call on district judges to grant so-called IFP status since that ability was restricted by *Perroton* to "courts of the United States." Prof. Markell was a bankruptcy judge in Las Vegas and a panelist on the Ninth Circuit BAP before returning to teaching.

The majority's opinion does not address the ability of bankruptcy courts or BAPs to issue writs under the version of the All Writs Act contained in Section 105(a) of the Bankruptcy Code. The majority overruled a 2002 decision by the Ninth Circuit's BAP, which had held they had power to issue writs.

The opinion is *Ozenne v. Chase Manhattan Bank (In re Ozenne)*, 818 F.3d 514 (9th Cir. March 25, 2016).

Lehman co-underwriters are stuck with worthless contribution claims.

Second Circuit Broadly Reads Claim Subordination Under Section 510(b)

Co-underwriters with Lehman Brothers Inc. do not have contribution claims against the liquidated investment bank arising from offerings in which the Lehman broker was the lead underwriter in the sale of its parent's securities, according to a Dec. 14 decision in the Second Circuit upholding two lower courts.

The appeals court decision, by Circuit Judge Dennis Jacobs, revolved around an interpretation of Section 510(b), which subordinates claims based on the purchase or sale of securities to the same level as the securities themselves. *Lehman* presented a twist on the typical case because the co-underwriters were raising claims against the Lehman broker that was not the issuer of the securities.

Bankruptcy Judge James M. Peck ruled in January that hedge fund managers and underwriters in substance do not have claims to be paid in the Lehman brokerage liquidation under the Securities Investor Protection Act. Judge Peck's opinion was upheld in September 2015 by District Judge Shira A. Scheindlin in Manhattan. Judge Jacobs' opinion for the appeals court adopted Judge Scheindlin's rationale.

The underwriters filed contribution claims against the Lehman broker as lead underwriter, claiming that the bankrupt brokerage was liable to them for its share of the costs of defense and settlements after being sued for misstatements when the Lehman parent sold its securities. One underwriter claimed $78 million, while another sought $250 million.

The underwriters argued that Section 510(b) did not apply because the securities were sold by the Lehman parent, not by the Lehman brokerage itself. Judge Jacobs rejected the underwriters' narrow reading of the statute. The circuit's opinion is based on both the rules of statutory construction and legislative history.

Judge Jacobs held that "claims arising from securities of a debtor's affiliate should be subordinated in the debtor's bankruptcy proceeding to all claims or interests senior or equal to claims in the bankruptcy proceeding that are of the same type as the underlying securities."

In the affiliate context, the underwriters unsuccessfully contended that Section 510(b) is invoked only if the affiliated companies are substantively consolidated or if one affiliate guaranteed payment of another's obligation. Judge Jacobs saw no "textual hook" for a narrow reading of the statute.

The *Lehman* decision shows how a law review article can be pivotal more than 40 years after publication. In discerning congressional intent, Judge Jacobs relied heavily on a 1973 article by Profs. Homer Kripke and John Slain advocating for the "risk-allocation rationale" that was eventually adopted in Section 510(b).

Quoting the circuit's 2006 *Enron* decision, Judge Jacobs said that the rationale behind Section 510(b) prevents "disappointed shareholders from recovering their investment losses by using fraud and other securities law claims to bootstrap their way to parity with general unsecured creditors." He added that every lower court to confront the affiliate-securities issue reached the same result.

When affiliates have differing capital structures, Judge Jacobs said it could be "messy" to figure out where the subordinated claims should lodge in the distribution waterfall. Since the bankruptcy court is a court of equity, and bankruptcy judges have experience in deciding how to classify claims, Judge Jacobs said that bankruptcy courts are "best situated" to pigeonhole subordinated claims into distribution schemes. In the *Lehman* case, he said, it won't much matter because unsecured creditors, whose claims have priority over the underwriters' subordinated claims, will consume the entire unsecured estate.

The opinion is *BMO Capital Markets Corp. v. Giddens (In re Lehman Brothers Inc.)*, 808 F.3d 942 (2d Cir. Dec. 14, 2015).

Judge Ambro allows non-debtors to sue for damages from dismissal of involuntary petition.

Third and Ninth Circuits Split on Preemption of Non-Debtor Claims by Section 303(i)

The Third Circuit split with the Ninth by holding that Section 303(i) does not preempt claims by non-debtors against creditors who mount unsuccessful involuntary bankruptcy petitions.

The story began eight years ago when secured lenders filed an involuntary petition against an individual and businesses he owned. The case became a nightmare for the creditors after the bankruptcy court dismissed the petitions. This year, the Eleventh Circuit held that a procedural snafu by the lenders' attorneys left their clients saddled with $1.12 million in compensatory damages and $5 million in punitive damages under Section 303(i)(2). Last year, the Eleventh Circuit upheld an award of more than $1 million in attorneys' fees under Section 303(i)(1).

Another chapter in the saga began when the owner's wife and several of his non-debtor companies filed suit in district court against the lenders for tortious interference with contracts and business relationships. The district court in Pennsylvania dismissed the complaint, believing that the state law claims were preempted by Section 303(i)(1), which allows the court to award costs and attorneys' fees "in favor of the debtor" when an involuntary petition is dismissed. Section 303(i)(2) permits the imposition of compensatory or punitive damages if the involuntary petition was filed in bad faith.

In his Aug. 29 opinion for the Philadelphia-based appeals court, Circuit Judge Thomas Ambro described the case as involving field preemption, not express preemption or conflict preemption. Field preemption, he said, results when the field is reserved for federal regulation, leaving no room for state regulation. Nevertheless, Congress must show "clear and manifest intent" to preempt state law because there is a "sturdy 'presumption against preemption.'"

The statute by itself is "insufficient for field preemption," Judge Ambro said, because Section 303(i) is "silent as to potential remedies for non-debtors." He said the court must "not lightly infer from congressional silence the intent to deprive some persons of a judicial remedy for an abuse of the bankruptcy system."

In the same vein, he said "it would be inconsistent with the remedial purpose of Section 303(i) to preempt state law remedies for non-debtors that can likewise be harmed by involuntary bankruptcy petitions."

In dismissing the complaint, the district court relied on the Ninth Circuit's 2005 decision called *In re Miles*, where the San Francisco-based court dismissed non-debtors' claims on the ground of complete preemption arising from Section 303(i).

Judge Ambro said *Miles* was not "persuasive," in part because the decision "is inconsistent with the presumption against preemption."

Judge Ambro was a bankruptcy lawyer before elevation to the circuit court. To read ABI's discussion of this year's Eleventh Circuit opinion on punitive and compensatory damages, click here.

The opinion is *Rosenberg v. DVI Receivables XVII LLC*, 15-2622 (3d Cir. Aug. 29, 2016).

Consumer Bankruptcy

Fair Debt Collection Practices Act and RICO

California district courts split on whether filing stale claims violates RICO.

Supreme Court's Upcoming FDCPA Decision Also May Govern RICO Suits

In deciding whether the filing of a stale claim violates the FDCPA, the Supreme Court likely will lay down precedent to resolve an issue pending in the Ninth Circuit: Does a debt collector violate RICO by filing proofs of claim based on debts where collection would be barred outside of bankruptcy by the statute of limitations?

On Oct. 11 the Supreme Court granted *certiorari* and agreed to resolve a conflict among the circuits by hearing *Midland Funding LLC v. Johnson*, where the Eleventh Circuit held that a debt collector violates the federal Fair Debt Collection Practices Act, or FDCPA, by filing a stale claim. The high court will also decide whether the later adoption of the Bankruptcy Code impliedly repealed the FDCPA as to the filing of stale claims in bankruptcy.

On a parallel track, the Ninth Circuit is primed to settle a split among district courts in California by deciding whether filing stale claims in chapter 13 cases violates the federal Racketeer Influenced and Corrupt Organizations Act, or RICO. Within weeks of one another, district courts in the Southern District of California filed opinions reaching diametrically opposite results. One held that persistently filing stale claims violates RICO, while another held that it does not.

Practically speaking, the Supreme Court may allow the business of collecting stale debts in bankruptcy to prosper and grow. Or, the Supreme Court may effectively kill the business, leaving debt collectors with large class action liability for thousands of claims they already filed.

The RICO Suits

On the same day in September 2015, lawyers filed companion class actions in San Diego. One was aimed at debt collector Midland Funding LLC, while the other targeted LVNV Funding LLC, another leader in the collection of stale claims in bankruptcies. Both suits alleged that the debt collectors violated RICO by making a business out of filing "massive" numbers of claims based on debts where recovery outside of bankruptcy would be barred by the statute of limitations.

The suits were assigned to different district judges in San Diego.

The debt collectors base their business on the premise that they are allowed to file proofs of claim because a stale debt is not extinguished since the statute of limitations merely permits the debtor to raise an affirmative defense. Because they pay such a tiny amount for each stale claim, the collection of just a small percentage of claims makes the business profitable.

The debt collectors typically file proofs of claim complying with the Bankruptcy Rules by laying out facts indicating that the statute of limitations has lapsed. They assume that trustees or debtors in many instances will not read the claims or will lack the resources or incentive to file objections to otherwise time-barred claims.

One RICO Suit Dismissed, the Other Survives

In the first-filed case, *Arce v. LVNV Funding LLC*, District Judge Larry Alan Burns wrote a two-page decision in April dismissing the RICO complaint with prejudice on the authority of the Ninth Circuit's 2002 decision in *Walls v. Wells Fargo Bank NA*. *Walls* is one of the cases that the Supreme Court will either impliedly uphold or reverse in *Johnson*.

In *Walls*, the Ninth Circuit dismissed a lawsuit aimed at a debt collector, holding that the Bankruptcy Code provides a bankrupt's only recourse for a violation of the discharge injunction.

The plaintiffs filed an appeal to the Ninth Circuit in *Arce*. The defendant submitted its answering brief on Oct. 6. Likely as not, the Ninth Circuit will wait for the Supreme Court to rule on *Johnson* before deciding *Arce*.

In May, District Judge M. James Lorenz disagreed with Judge Burns and denied the debt collector's motion to dismiss. In *Rivera v. Encore Capital Group*, Judge Lorenz held that systematically filing proofs of claim based on stale debts states a cause of action for violation of RICO.

Reading *Walls* narrowly, Judge Lorenz believes that in adopting RICO, "Congress did intend to provide a statutory cause of action via which bankruptcy debtors could assert bankruptcy fraud claims." He rested his conclusion in part on 18 U.S.C. Section 1961(1)(D), which provides that fraud in a bankruptcy case constitutes an act of "racketeering."

On the question of implied repeal, Judge Lorenz said that "Congress certainly did not intend that the Bankruptcy Code operate as a substitute for RICO." Nor did he see the Code and RICO as being in "irreconcilable conflict."

On an issue that the Supreme Court will squarely address in *Johnson*, Judge Lorenz rejected the notion that the Bankruptcy Code "authorizes and endorses" the filing of stale claims. He said that "systematically" filing stale claims "*en masse*" is "offensive to the provisions" of the

Bankruptcy Code and therefore states a racketeering claim because bankruptcy was "enacted to provide for the orderly disposition of legitimate claims."

The debt collector has a pending motion asking Judge Lorenz to certify an interlocutory appeal to the Ninth Circuit or stay the suit until the appeals court decides *Arce*.

Implications of a *Johnson* Decision

If the Supreme Court decides in *Johnson* that the Bankruptcy Code did not impliedly repeal the FDCPA, the result likely would apply equally to RICO, allowing suits like *Arce* and *Rivera* to survive Rule 12(b)(6) motions.

If the Supreme Court does find implied repeal in *Johnson*, it is possible, although perhaps unlikely, that RICO suits will nonetheless survive. In RICO cases, plaintiffs have the additional argument that Congress specifically made bankruptcy fraud an act of racketeering. Compared with the FDCPA, a civil statute, it's a longer jump to the conclusion that the Bankruptcy Code impliedly repealed a provision in the federal criminal code.

Assuming no implied repeal, the Supreme Court will also decide whether the Bankruptcy Code permits or encourages the filing of stale claims. If the high court interprets the Code as providing a safe harbor for stale claims, RICO suits likely will meet the same fate.

To read ABI's discussion of the grant of *certiorari* in *Johnson*, click here.

The opinion by Judge Lorenz is *Rivera v. Encore Capital Group*, 15-2112 (S.D. Cal. May 27, 2016); and the opinion by Judge Burns is *Arce v. LVNV Funding LLC*, 15-2111 (S.D. Cal. April 12 2016).

Rochelle's Daily Wire

Vigorous dissents in the Seventh and Fourth Circuits accentuate splits on the FDCPA.

Circuit Split Deepens on Stale Claims as Violations of the FDCPA

Deepening an existing split of circuits, the Fourth Circuit held in a 2-1 opinion that filing a time-barred claim does not violate the federal Fair Debt Collection Practices Act, or FDCPA, because the Bankruptcy Code and Rules invite creditors to file proofs of claim based on stale debts.

The Seventh, Eighth and Second Circuits already held that the FDCPA is not violated when a creditor files a claim based on a debt where collection is precluded by the statute of limitations. Prior to the Fourth Circuit's decision on Aug. 25, the most recent opinion came down on Aug. 10 in a 2-1 ruling from the Seventh Circuit, with Chief Judge Diane P. Wood dissenting.

On the other side of the fence, the Eleventh Circuit holds that filing a stale claim violates the FDCPA.

The Supreme Court might visit the issue as soon as the term beginning in October. In *Johnson v. Midland Funding LLC*, the Eleventh Circuit split with the Second and Ninth Circuits in May by holding that the Bankruptcy Code did not impliedly repeal the FDCPA. The debt collector filed a motion for rehearing *en banc* that was denied on Aug. 19.

On Aug. 25, the debt collector in *Johnson* filed a motion imploring the Eleventh Circuit to stay the issuance of the mandate. In the motion, the debt collector promised to file a petition for *certiorari* and predicted the Supreme Court would hear the case to resolve the splits of circuits.

The Fourth Circuit Majority

In the Fourth Circuit case, a debt collector purchased debts and filed proofs of claim in two bankruptcies based on obligations where collection would be barred by the statute of limitations. The debtors objected to the claims and mounted FDCPA lawsuits. The debt collector stipulated to disallowance of the claims, and the bankruptcy court granted motions to dismiss the FDCPA suits. The Fourth Circuit allowed direct appeals.

In his majority opinion, Fourth Circuit Judge Henry F. Floyd acknowledged that filing a *lawsuit* based on a time-barred claim violates the FDCPA. He then proceeded to determine whether the debt collector met the initial definitional requirements of the FDCPA.

First, he held that filing a claim is a debt-collection activity regulated by the FDCPA. Next, he considered whether filing a stale claim in bankruptcy violates the FDCPA in light of the Bankruptcy Code.

On that score, Judge Floyd said that the statute of limitations only bars a remedy but does not extinguish the underlying debt. Consequently, he said, the debt collector held a "claim" within the broad definition of that term contained in the Bankruptcy Code. He said that the Bankruptcy Code "nowhere suggests that such debts are not to be filed in the first place." He even said that recent amendments to the Bankruptcy Rules – requiring the disclosure of facts showing that a claim is time barred – "suggest[] that the Code contemplates that untimely debts will be filed as claims but ultimately disallowed."

Judge Floyd then ruled that permission granted by the Bankruptcy Code to file stale claims overrides a violation of the FDCPA that would result if that statute were considered alone.

Judge Floyd admitted that trustees sometimes lack the time or resources for objecting to claims, thus permitting the allowance of stale claims, which dilute recoveries by creditors with legitimate claims.

Although Judge Floyd said "we appreciate the harm," he said the solution would lie in "allocating additional resources to trustees" or by having U.S. Trustees rigorously enforce trustees' obligations to object to claims.

The Fourth Circuit Dissent

Circuit Judge Albert Diaz agreed that filing a claim is a debt-collection activity, but he otherwise dissented, believing that the debt collector's conduct was inconsistent with the FDCPA.

Judge Diaz said that the debt collector's "sharp practice is misleading and unfair to debtors and other creditors." He characterized the creditor as playing the odds to "garner a payoff on unenforceable debts" while "sheepishly" admitting that the claim is "meritless" if someone objects. In his opinion, the debt collector was "exploiting a weakness in the bankruptcy system and preying on potential error to collect on debts where it should not." The business practice, he said, "subverts a core purpose of bankruptcy by diverting estate assets from the creditors entitled to receive them."

For those reasons, Judge Diaz would hold that the FDCPA does not impliedly repeal the FDCPA.

Because the majority did not reach the question, Judge Diaz said he would have held that the FDCPA "on its own terms" would apply to filing time-barred claims. On that score, he would follow the Third, Seventh and Eleventh Circuits, which have held that the FDCPA and the Bankruptcy Code can coexist and that creditors can comply with both simultaneously, because the Bankruptcy Code does not compel creditors to file proofs of claim.

The result in the Fourth Circuit cannot be said to be the result of a conservative bench. Both Judges Floyd and Diaz were appointed by President Obama.

To read ABI's discussions of the Seventh and Eleventh Circuit Opinions, click here and here.

The opinion is *Dubois v. Atlas Acquisition LLC (In re Dubois)*, 15-1945 (4th Cir. Aug. 25, 2016).

ROCHELLE'S DAILY WIRE

Over dissent, the Seventh Circuit creates a safe harbor for pursuing stale claims in bankruptcy.

Seventh Circuit Widens Split on Filing Stale Claims as Violations of the FDCPA

The conflict of circuits widened when the Seventh Circuit handed down a split decision on Aug. 10 holding that filing a proof of claim based on a stale debt does not violate the federal Fair Debt Collection Practices Act, or FDCPA.

In the majority opinion by Circuit Judge Joel M. Flaum, the Chicago-based appeals court took sides with the Courts of Appeals for the Eighth and Second Circuits, which both hold that the FDCPA is not violated when a creditor files a proof of claim based on a debt where collection is precluded by the statute of limitations. In dissent, Chief Circuit Judge Diane P. Wood would have followed the Eleventh Circuit, which holds that filing a stale claim violates the FDCPA.

In the Eleventh Circuit case from 2014, *Crawford v. LVNV Funding LLC,* the Supreme Court denied *certiorari* last year.

The Stale Debt Collection Business

An industry was created when debt collectors began paying small amounts to buy debts where statutes of limitations would preclude recovery. The claim purchasers file proofs of claim when the debtors file bankruptcy. The purchasers' claim forms typically disclose all required information that should alert trustees and debtors to the fact that collection of the debts would be time-barred.

The business model is based on the assumption that there will be no objection to the claims in some cases, either through inadvertence or because objecting is not economically justifiable or is not covered by counsels' flat-fee arrangements.

Since the creditors will have paid so little for the claims, the allowance of just a few will still make the business profitable.

The Majority Opinion

The case in the Seventh Circuit was a consolidated appeal from three decisions, two from Indianapolis and one from Chicago. In all three, the district judges dismissed the FDCPA suits, holding that the Bankruptcy Code provides a safe harbor that permits filing stale claims. The appeal was argued on June 1.

The debtors contended that the claims-filing process is reserved for enforceable claims. They relied in large part on the Seventh Circuit's 2013 *Phillips* opinion holding that a *lawsuit* to collect a stale debt violates the FDCPA.

Like other courts reaching the same conclusion, the Seventh Circuit reasoned that there is no FDCPA violation because the Bankruptcy Code's expansive definition of "claim" and other provisions combine to allow a debt collector to file a stale proof of claim when a lawsuit on the same debt would result in liability.

Examining the claims-filing and allowance process, Judge Flaum concluded that the "Bankruptcy Code contemplates that creditors will file proofs of claim for unenforceable debts . . . and that the bankruptcy court will disallow those claims on the debtor's objection." The "established procedures," he said, "confirm that the Bankruptcy Code anticipates that creditors will file proofs of claim on stale debts."

Although the Bankruptcy Code allows creditors to file stale claims, the question remained as to whether the debt collector's conducted violated the FDCPA.

Unlike the filing of a lawsuit where the debtor does not have a lawyer automatically, Judge Flaum said that the problem is "less acute" in a "counseled" bankruptcy where the debtor ordinarily has a lawyer and trustees are obliged to object to defective claims. Since a "reasonably competent" lawyer would know the claim to be stale, he said there was no deceptive, misleading, unfair or abusive conduct giving rise to FDCPA liability.

Judge Flaum included a significant carveout in his holding. If the bankrupt has no lawyer, "this opinion does not foreclose relief under the FDCPA," he said.

The Dissent

Judge Wood found little difference from *Phillips* where filing suit on a stale claim violates the FDCPA. Although the Bankruptcy Code allows creditors to file claims based on contingent or unliquidated debts, she said those categories do not cover "a concededly stale debt."

The "public policy" shown in Bankruptcy Rule 9011(b) "demands that we do not protect frivolous, bad-faith, or unfounded claims," Judge Wood said.

Judge Wood would have followed the Eleventh Circuit because, she said, it is "unrealistic to think that the *pro se* litigant or the busy trustee will catch every scheduled stale claim."

The majority opinion did not reach an issue in one of the district court decisions. In the Chicago case, the district judge also dismissed on the ground of *res judicata* because there was no objection to the claim before the chapter 13 plan was confirmed. In July, a district judge in Georgia held that *res judicata* does not apply. To read ABI's discussion of *Willis v. Cavalry Investment LLC*, click here.

To read about the Eighth Circuit's opinion in *Nelson v. Midland Credit Management Inc.*, click here.

The circuits are also split on whether the later-adopted Bankruptcy Code impliedly repealed the FDCPA with respect to debtors who are in bankruptcy. Sensibly, the Supreme Court should grant *certiorari* and decide both circuit splits at once.

The opinion is *Owens v. LVNV Funding LLC*, 15-2044 (7th Cir. Aug. 10, 2016).

Eighth Circuit says bankruptcy adequately protects debtors from assertion of stale claims.

Circuits Starkly Split on Filing Time-Barred Claims as Violations of the FDCPA

There is now a stark split among the circuits on the question of whether the filing of a claim based on a time-barred debt violates the federal Fair Debt Collection Practices Act, or FDCPA.

In 2014, the Eleventh Circuit held in *Crawford v. LVNV Funding LLC* that filing a proof of claim barred by a statute of limitations violates the FDCPA. On July 11, the Eighth Circuit ruled to the contrary, holding that filing an accurate proof of claim is no violation of the FDCPA even though, the court implies, attempting to collect a similarly time-barred debt outside of bankruptcy would give rise to FDCPA liability.

In *Crawford*, the Eleventh Circuit said it was bent on stemming what it called a “deluge” of claims filed in bankruptcies that attempt to collect “debts deemed unenforceable under state statutes of limitations.”

The Eleventh Circuit analyzed the issue in part by focusing on the effect that the filing of stale claims has on the bankruptcy process and on creditors. Because they ordinarily will not benefit from expunging claims, debtors in chapter 7 cases have no incentive for objecting to stale claims, the Atlanta-based circuit court said.

The Eleventh Circuit noted that chapter 7 trustees also may not object, given their meager compensation. Likewise, chapter 13 debtors with so-called pot plans similarly have no incentive for objecting to time-barred claims. Consequently, creditors with enforceable claims will have diminished recoveries if creditors with stale claims receive distributions from limited funds, because trustees and debtors do not object comprehensively to claims.

The Eighth Circuit’s opinion by Circuit Judge Duane Benton said that the Eleventh Circuit’s *Crawford* decision “ignores the differences between a bankruptcy claim and actual or threatened litigation.”

Judge Benton interpreted the Eleventh Circuit as holding that filing a claim stemming from a stale debt violates the FDCPA’s “prohibitions against unfair, unconscionable, deceptive, or misleading conduct.” Disagreeing with *Crawford*, Judge Benton said that the “bankruptcy process protects against such harassment and deception.”

"Unlike defendants facing a collection lawsuit," Judge Benton said that "a bankruptcy debtor is aided by 'trustees who owe fiduciary duties to all parties and have a statutory obligation to object to enforceable claims.'" He also said that "debtors have less at stake than a collection defendant" because their liabilities are capped by the loss of non-exempt property.

"There is no need to protect debtors who are already under the protection of the bankruptcy court, and there is no need to supplement the remedies afforded by bankruptcy itself," Judge Benton said.

One or more FDCPA cases may be headed for the Supreme Court, as early as the term to begin in October, because the Eleventh Circuit handed down *Johnson v. Midland Funding LLC* on May 24, holding, contrary to Second and Ninth Circuits, that the later-adopted Bankruptcy Code did not impliedly repeal the FDCPA with respect to debt collectors who file claims barred by statutes of limitations.

The Eleventh Circuit in *Johnson* sided with the Seventh Circuit's *Randolph* decision from 2004, which had held that debt collectors can comply with both the Bankruptcy Code and the FDCPA. In *Johnson*, there is a pending petition for rehearing *en banc*. To read ABI's analysis of *Johnson*, click here.

The opinion is *Nelson v. Midland Credit Management Inc.*, 15-2984, 2016 BL 221120 (8th Cir. July 11, 2016).

ROCHELLE'S DAILY WIRE

Appeals court finds no 'irreconcilable conflict' between the FDCPA and the Bankruptcy Code.

Eleventh Circuit Rules Against Debt Collectors, Deepening Split of Circuits on the FDCPA

Differing with the Second and Ninth Circuits, the Eleventh Circuit deepened an existing split of circuits, opening the door for the Supreme Court to decide whether the Bankruptcy Code impliedly repealed the federal Fair Debt Collection Practices Act to the extent of allowing debt collectors to file claims that are barred by statutes of limitations.

The ruling by Circuit Judge Beverly B. Martin on May 24 was not a surprise, because the Eleventh Circuit had held in 2014 in *Crawford v. LVNV Funding LLC* that filing a stale claim barred by a statute of limitations violates the FDCPA. In *Crawford*, the appeals court did not consider and explicitly left open the question of whether the later-adopted Bankruptcy Code impliedly repealed the FDCPA, thereby allowing the filing of claims based on stale debts.

Judge Martin's opinion, which came down less than six weeks after oral argument, answered the unresolved question by holding that there is no irresolvable conflict between the two statutes because they "can be construed together in a way that allows them to coexist."

While the Bankruptcy Code "certainly allows all creditors to file proofs of claim in bankruptcy cases," Judge Martin said that the "Code does not at the same time protect those creditors from all liability." Consequently, she said that a "particular subset of creditors – debt collectors – may be liable under the FDCPA for bankruptcy filings they know to be time-barred." As a result, she reversed the lower court in two cases where District Judge William H. Steele from Mobile, Ala., dismissed FDCPA suits on the theory that the Bankruptcy Code allows the filing of stale claims.

The policy underpinning *Crawford* was impossible to ignore. In that case, the appeals court said it was bent on stemming what it called a "deluge" of claims filed in bankruptcy attempting to collect "debts deemed unenforceable under state statutes of limitations."

Because they do not stand to benefit, debtors in chapter 7 cases have no incentive for objecting to stale claims. Given their meager compensation, chapter 7 trustees similarly may not object. Likewise, chapter 13 debtors with so-called pot plans also have no incentive for objecting to time-barred claims. Consequently, creditors with enforceable claims will have diminished recoveries. It is also noteworthy that an industry was created where a few companies pay miniscule sums to buy stale claims in bulk, knowing that even a few recoveries will make their businesses profitable.

Judge Steele declined to follow *Crawford*'s policy insinuation because, in his opinion, "[a] clearer demonstration of irreconcilable conflict would be difficult to imagine." He analyzed Alabama law as meaning that the statute of limitations only extinguishes the remedy, not the debt itself. He then surveyed the Bankruptcy Code and its broad definition of "claim," and concluded that it permits the filing of a claim barred by a statute of limitations. Judge Steele then held that the Bankruptcy Code impliedly repealed the FDCPA when it comes to filing stale claims.

On the issue of implied repeal, Circuit Judge Martin cited older Supreme Court authority for the proposition that implied repeal results when there is an "irreconcilable conflict" between two federal statutes. She then cited the Supreme Court's 2007 *National Association of Home Builders* opinion for the principle that implied repeal is "not favored" and will not be presumed "unless the intention of the legislature to repeal is clear and manifest."

Given that the FDCPA makes only debt collectors liable for filing stale claims, Judge Martin reversed Judge Steele because there is no "irreconcilable conflict" between the two statutes.

Although Judge Martin's decision does not mention, cite or criticize the circuits that have held to the contrary, her opinion refutes the principal arguments espoused by those who believe there is implied repeal. The Eleventh Circuit is not alone. The Seventh Circuit held in *Randolph* in 2004 that the two statutes are not in irreconcilable conflict, although *Randolph* did not deal with stale claims; it involved FDCPA sanctions for violating the automatic stay.

The Eleventh Circuit decision therefore becomes a prime candidate for Supreme Court review. How soon that might occur is open to doubt because the losing debt collector can file a motion for rehearing *en banc*. The odds of success do not seem great because the circuit court denied *en banc* rehearing in *Crawford*, with no judge even requesting that the judges be polled. A *certiorari* petition was also denied. The new case is a better candidate for *certiorari* because *Crawford* did not raise the question of implied repeal.

The opinion is *Johnson v. Midland Funding LLC*, 15-11240, 2016 WL 2996372 (11th Cir. May 24, 2016).

Circuit split grows on the conflict between the Bankruptcy Code and the FDCPA.

Second Circuit Charts a New Course Favoring Debtors on the FDCPA

The Second Circuit handed down a debtor-friendly opinion on Jan. 4 accentuating an existing split of circuits and laying the foundation for the Supreme Court to decide whether the Bankruptcy Code precludes claims to any extent under the federal Fair Debt Collection Practices Act, or FDCPA.

A woman confirmed a five-year chapter 13 plan with monthly payments on her home mortgage, including payments to cure arrears. After completing her plan payments, she got a discharge in 2013 and soon thereafter defaulted on the mortgage.

The loan servicer dunned her for pre-discharge arrears and post-discharge payments she missed. The woman responded by suing for violations of the FDCPA, contending the lender was attempting to collect personal obligations on the mortgage that were discharged.

A district judge in Rochester, N.Y., dismissed the suit, holding that the Bankruptcy Code provided the debtor's exclusive remedy for attempting to collect a discharged debt. The district judge believed the proper procedure would have been a motion for contempt of the discharge injunction under Section 105(a).

Circuit Judge Jon O. Newman reversed and reinstated the suit in an opinion largely focusing on the concept of implied repeal.

One federal statute does not supersede another. Instead, when there is an "irreconcilable conflict" between two federal statutes, Judge Newman said the question is whether all or part of the earlier law was repealed "by implication," a concept that is "disfavored."

Judge Newman's opinion was constrained by the circuit's 2010 decision *Simmons v. Roundup Funding*, which barred FDCPA claims during the pendency of a bankruptcy. He interpreted *Simmons* to mean that the FDCPA was inapplicable to claims during bankruptcy. That case, he said, did not mean that the FDCPA was impliedly repealed.

Judge Newman was able to reach a different result, and reinstate the FDCPA suit, by distinguishing the facts in *Simmons*, where the claim arose before discharge. The new case, argued in October, was based on actions taking place after discharge, when the debtor no longer had protection from the bankruptcy court, the circuit opinion said.

There is an extant conflict among the circuits, according to Judge Newman. The Ninth Circuit in 2002, he said, precludes FDCPA claims brought during bankruptcy. The Seventh Circuit, in 2004, said the statutes only "overlap" and lack any "irreconcilable conflict," enabling debt collectors able to comply with both simultaneously.

The Third Circuit similarly found no implied repeal.

Distinguishing *Simmons*, the Jan. 4 decision holds that the Bankruptcy Code did not "broadly repeal" the FDCPA for claims based on alleged violation of the discharge injunction.

Distinguishing the facts in *Simmons* rests tenuously on the notion that a debtor has no protection from the bankruptcy court after discharge. In reality, the debtor could reopen the case to enforce the discharge injunction and seek damages for contempt. In that respect, the new case and *Simmons* lay the groundwork for rehearing *en banc*, where all active circuit judges could consider if the Bankruptcy Code ever precludes claims under the FDCPA, since the Second and Seventh Circuits are not on the same page.

When debt collectors allegedly violate either the automatic stay or the discharge injunction, debtors prefer using the FDCPA because it carries more favorable remedies, including the automatic recovery of the plaintiff's attorneys' fees if the claim is upheld.

The opinion is *Garfield v. Ocwen Loan Servicing LLC*, 811 F.3d 86 (2d Cir. Jan. 4, 2016).

Louisiana bankruptcy judge splits with Eleventh Circuit's* Crawford *decision.

Even Without Implied Repeal, Filing a Stale Claim Does Not Violate the FDCPA

Bankruptcy Judge Jeffrey P. Norman wrote the antidote to *Crawford v. LVNV Funding LLC*, the Eleventh Circuit case from 2014 holding that filing a time-barred proof of claim violates the federal Fair Debt Collection Practices Act, or FDCPA.

Although Judge Norman held in his July 28 opinion that the later-adopted Bankruptcy Code did not impliedly repeal the FDCPA, he ruled that filing a factually accurate and complete proof of claim did not state a claim for violation of the FDCPA.

Judge Norman, of Shreveport, La., pointed out how the circuit courts are evenly split, with no decision yet from the Fifth Circuit. Three circuits – the Second, Eighth and Ninth – hold that the Bankruptcy Code precludes asserting claims under the FDCPA, while the Third, Seventh and Eleventh Circuits allow FDCPA claims brought by debtors. The Second Circuit recently narrowed its prior decision by holding that a debtor who has received a discharge can mount an FDCPA claim. *See* *Garfield v. Ocwen Loan Servicing LLC*, 811 F.3d 86 (2d Cir. Jan. 4, 2016).

In the case before Judge Norman, a purchaser of time-barred debts filed a $760 claim. After the debtor initiated an adversary proceeding for violation of the FDCPA, the creditor filed a motion for leave to withdraw the claim, hoping that withdrawal would moot the FDCPA suit.

Judge Norman allowed withdrawal of the claim under Bankruptcy Rule 3006, but he held that the damage already had been done. Violation of the FDCPA occurred when the claim was filed, so that withdrawal of the claim did not moot the adversary proceeding.

While an FDCPA claim by a debtor is not categorically prohibited, Judge Norman reached what he called a "more nuanced" conclusion by holding that the creditor's properly completed claim form did not lay out a plausible violation of the FDCPA.

He held that filing an accurate and complete claim does not represent harassment or abuse and does not entail the use of any "false, deceptive or misleading representation." Since nothing in the proof of claim was untruthful, Judge Norman similarly held that it was not "unfair or unconscionable."

Judge Norman did not say that a debtor can never assert a valid FDCPA claim based on a time-barred debt. He gave the debtor leave to amend her complaint, "if possible."

In *Crawford*, 758 F.3d 1254, the Eleventh Circuit was bent on ending what it called a "deluge" of claims based on time-barred debts. The appeals court's decision explained why the availability of claim objections and the duties of trustees did not obviate valid FDCPA suits. The circuit intended to prevent debtors and trustees from spending money objecting to stale claims. In those situations where objections are not economically warranted, the Eleventh Circuit wanted to ensure that recoveries by creditors with valid claims would not be diluted.

Although Judge Norman rebuts the arguments in *Crawford*, he does not address that case directly.

There are other significant holdings in Judge Norman's opinion. He held that the creditor had impliedly consented to entry of final judgment by not raising a *Stern* objection before filing a motion to dismiss.

Under *Spokeo Inc. v. Robins*, 136 S. Ct. 1540, 194 L. Ed. 2d 635 (Sup. Ct. May 16, 2016), Judge Norman ruled that the debtor had constitutional standing by virtue of a "concrete and particularized" injury resulting at a minimum from incurring additional attorneys' fees in expunging the claim.

To read ABI's discussion of *Garfield*, click here. For *Spokeo*, click here.

The opinion is *Robinson v. JH Portfolio Debt Equities LLC (In re Robinson)*, 16-03004 (Bankr. W.D. La. July 28, 2016).

Georgia district judge confronts creditors who file claims based on stale debts.

An Allowed Claim Doesn't Bar an FDCPA Suit from Attacking the Same Debt

Assume that a creditor files a claim in a chapter 13 case, and neither the trustee nor the debtor objects. Can the debtor later mount a lawsuit against the creditor for filing a stale claim under the federal Fair Debt Collection Practices Act, or does *res judicata* preclude the FDCPA claim?

District Judge J. Randall Hall of Augusta, Ga., ruled on July 13 that *res judicata* does not apply.

A debtor had not made a payment on a debt since 1996 when she filed a chapter 13 petition in 2014. The creditor filed a proof of claim, even though collection would be barred by the statute of limitations. Neither the debtor nor the chapter 13 trustee objected to the claim.

After the bankruptcy court confirmed the plan, the debtor initiated a class suit in state court, alleging the creditor's routine filing of time-barred claims violates the FDCPA.

The creditor filed a motion to dismiss, which Judge Hall held in abeyance until the Eleventh Circuit decided *Johnson v. Midland Funding LLC* in May, creating a split of circuits by holding that the later-adopted Bankruptcy Code did not impliedly repeal the FDCPA with respect to debt collectors who file claims barred by statutes of limitations.

Naturally, Judge Hall ruled that *Johnson* "completely foreclosed" the lender's contention that the Bankruptcy Code supersedes the FDCPA because the Code permits filing stale claims. He still had to deal with the creditor's argument that the bankruptcy court's confirmation of the plan was a final judgment on the validity of the claim, thus barring the FDCPA suit on the grounds of *res judicata*.

Citing another court on the same issue, Judge Hall said that an "'FDCPA claim is an independent claim that has nothing to do with whether the underlying debt is valid.'" Where plan confirmation dealt with the validity or amount of the debt, he said the suit before him "is about whether defendants violated the FDCPA when they filed the proof of claim."

He also said that the FDCPA claim does not arise from the same facts and "does not involve the same cause of action."

The creditor wanted the suit referred to the bankruptcy court if its motion to dismiss were denied. Employing the concept of permissive withdrawal of the reference, Judge Hall kept the class suit, saying that litigation in district court would conserve the parties' and judicial resources. He also said that the district court was better situated to handle the litigation because it was a class action where the plaintiff demanded a jury trial.

To read ABI's discussion of *Johnson*, click here.

The opinion is *Willis v. Calvary Investment LLC*, 14-227 (S.D. Ga. July 13, 2016).

Dischargeability

High court should revisit* Kelly v. Robinson *from 1986, circuit court says.

Ninth Circuit Says 1980s Supreme Court Opinion Out of Step with Plain Meaning

The Ninth Circuit wrote an opinion on April 14 indirectly saying that the Supreme Court should overrule *Kelly v. Robinson*, where the high court held in 1986 that criminal restitution imposed as a condition for probation is nondischargeable under Section 523(a)(7).

Writing for the appeals court, Circuit Judge John B. Owens said that *Kelly* "untether[ed] statutory interpretation from the statutory language." That approach, he said, "has gone the way of *NutraSweet* and other relics of the 1980s and led to considerable confusion." He then went on to cite circuit court decisions from around the country that distinguish *Kelly* to the vanishing point.

Section 523(a)(7) bars the discharge of "a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit" that is not compensation for "actual pecuniary loss."

Although restitution in *Kelly* was payable to the victim of the crime and therefore seemingly outside of the boundaries of Section 523(a)(7), the Supreme Court nonetheless held that the debt was nondischargeable based on a "deep conviction" that bankruptcy courts should not invalidate state criminal proceedings.

The case before the Ninth Circuit involved a lawyer who violated state law by charging a client in advance for a mortgage modification. The client fired the lawyer and got an arbitration award requiring repayment of the entire fee. When the lawyer did not pay, the state bar suspended the lawyer's license to practice until she repaid the fee.

Filing a chapter 7 petition, the lawyer sued the state bar in bankruptcy court under Section 525(a) for revoking a license "solely because" she had not paid a dischargeable debt. The bankruptcy court and the district court both held that the debt was nondischargeable.

On appeal, Judge Owens ruled that the fee was a dischargeable debt and reversed the lower courts. He relied in significant part on the Ninth Circuit's 2010 decision in *Findley*, which held that the costs associated with state bar disciplinary proceedings are nondischargeable.

In the case on appeal, Judge Owens said, there were no costs payable to the state that were assessed for disciplinary proceedings, only a debt for receiving a fee improperly from a client. Furthermore, the debt was "compensation for actual loss," not a fine or penalty.

If the debt were not dischargeable, Judge Owens said that fee disputes with other licensed professionals like doctors, dentists or barbers would lead to nondischargeable debts.

The opinion is *Scheer v. State Bar of California (In re Scheer)*, 819 F.3d 1206 (9th Cir. April 14, 2016).

Ninth Circuit decision based on policy, not statutory language, is wrong, S.D.N.Y. judge says.

New York Judge Rejects Ninth Circuit's *Ybarra* Doctrine that Revives Discharged Claims

A district judge in New York *declined* to adopt the Ninth Circuit's *Ybarra* doctrine allowing the revival of discharged claims, in the process reversing a bankruptcy court decision handed down in the aftermath of the chapter 11 liquidation of Residential Capital LLC, once the mortgage-servicing affiliate of Ally Financial Inc.

In 2005, the Ninth Circuit held in *Ybarra* that a counterclaim, otherwise discharged, would revive if the debtor were to initiate a lawsuit on a claim that seemingly had been resolved. In an opinion entered on Sept. 21, District Judge John G. Koeltl held that *Ybarra* — "not rooted in statutory interpretation but policy considerations" — was contrary to controlling Second Circuit authority.

ResCap implemented a chapter 11 plan in December 2013 and then sued dozens of mortgage-loan originators, mostly in district court in Minnesota, alleging breach of contract and indemnification for selling mortgages that violated underwriting standards. About a half dozen defendants, who had not filed proofs of claim in ResCap's bankruptcy, asserted counterclaims alleging that ResCap was liable for their attorneys' fees as a consequence of ResCap's own breach of the same contracts.

ResCap filed a motion in bankruptcy court in New York asking the judge to enjoin the mortgage originators from prosecuting their counterclaims, contending they were discharged by confirmation of the chapter 11 plan. ResCap nonetheless conceded that the defendants could use their claims for attorneys' fees in defense or setoff.

The bankruptcy judge denied the motion late last year, relying on the notion from *Ybarra* that the counterclaims were revived because ResCap sued after the plan's consummation.

The mortgage originators appealed and won.

Of apparent significance, Judge Koeltl said that ResCap's disclosure statement and plan supplement said that the liquidating trust would file suits against mortgage originators for breaches of warranties and representations in selling mortgages that ResCap subsequently securitized. Some of the appellants were even mentioned by name in ResCap's pre-confirmation filings.

The defendants all had notice of ResCap's bankruptcy but did not file proofs of claim. ResCap had sued them after the plan became effective.

For Judge Koeltl, the Second Circuit's 2009 post-*Ybarra* decision in *Ogle* was controlling. He understood the case to mean that a pre-bankruptcy contractual provision for attorneys' fees is a contingent claim that must be filed to avoid discharge. *Ogle*, he said, required reversing the bankruptcy court.

In *Ybarra*, the Ninth Circuit held that a debtor who voluntarily "returns to the fray" in the process revives counterclaims that otherwise were discharged. Judge Koeltl said there is no statutory basis for *Ybarra*. He also said he was bound by *Ogle* and the general principle that exceptions to discharge are narrowly construed. He said that the bankruptcy court had not cited *Ogle*.

Judge Koeltl insinuated that the Ninth Circuit itself narrowed *Ybarra* in a decision this month that might be read as meaning that the doctrine only applies if a dispute, settled during bankruptcy, erupted once again after discharge.

The opinion is *ResCap Liquidating Trust v. PHH Mortgage Corp (In re Residential Capital LLC)*, 16-034 (S.D.N.Y. Sept. 21, 2016).

ROCHELLE'S DAILY WIRE

Ninth Circuit employs a bankruptcy case to criticize local governments for 'self-generated revenue.'

Expenses of Jailing a Child Are Dischargeable, Ninth Circuit Holds

The Ninth Circuit made the world a safer place for parents of delinquent children when it held that none of the costs of incarceration qualify as a "domestic support obligation" that would render them nondischargeable under Section 523(a)(5).

The opinion is laced with criticism of the California state government for putting much of the cost of local government on the shoulders of the poor.

The appeal stemmed from a California state law making parents liable up to $30 a day for feeding and clothing a minor child in jail. The statute also makes parents liable for criminal defense costs.

The county billed a mother more than $16,000, which covered part of the cost of her son's incarceration. Although she sold her home to pay $9,500, the county got a judgment for almost $10,000.

The mother filed bankruptcy, listed the debt, and got a discharge in chapter 7. Contending that the judgment was for a domestic support obligation, or DSO, so that it was automatically excepted from discharge under Section 523(a)(5), the county continued attempting to collect the judgment.

The mother hauled the county into bankruptcy court for a declaration that the debt was discharged. The bankruptcy and the district courts both ruled in favor of the county. On appeal to the Court of Appeals, Ninth Circuit Judge Stephen Reinhardt wrote the opinion on Aug. 10 reversing and holding that incarceration costs are not DSOs.

Judge Reinhardt said that bankruptcy allows someone to shed "one's debts, but not one's most fundamental family obligations." Referring to the statute, he said the question was whether the debt was "in the nature of ... support." The amendments in 2005 affecting DSOs in Section 101(14A) only allowed collection by government agencies but did not alter the definition of DSOs, he said.

Judge Reinhardt said that even the costs of clothing and food were "incidental" to the "larger governmental purpose" of "public safety" and "reducing crime." "In short," he said, "the purpose of [the son's] detention was to enforce criminal law."

The debt was not a DSO because "the principal purpose of the county's custody over [her] son is public safety," even though the state legislature characterized the liability as support. In that regard, Judge Reinhardt said that "the way a state characterizes debt is relevant, though not conclusive."

The opinion ends with criticism of the state government for attempting to collect from the mother, who had committed no crime. Judge Reinhardt said that making the debt nondischargeable "would only detract from [the mother's] ability to fulfill her family support obligations."

He went further, saying that burdening the mother "hardly enhances the future welfare of the child." By "relentlessly pursuing" the mother, the state was raising "yet another obstacle to [the mother's] efforts to provide her son with the support about which the county claims to be so deeply concerned."

The concluding pages of the opinion include a critique of "a recurring problem of public entities imposing fiscal burdens on those who can least afford them." The appeals court lists parking tickets, police citations, court-imposed fees and fines as being among regressive taxes that "lay a debt trap for the poor."

The opinion is *Rivera v. Orange County Probation Department (In re Rivera)*, 14-60044 (9th Cir. Aug. 10, 2016).

Posner chides bankruptcy judge for reluctance to enter money judgment.

Power to Issue Money Judgment for Nondischargeable Debt Survives after *Stern*

Seventh Circuit Judge Richard A. Posner reassured bankruptcy judges that they do not commit constitutional error by granting a money judgment for a debt declared nondischargeable.

The bankruptcy judge, upheld in district court, ruled that a debt owing by an individual chapter 7 debtor was nondischargeable. Doubting whether he had constitutional power to issue a final judgment, the bankruptcy judge refused to enter a money judgment for the nondischargeable debt and was again upheld on appeal.

Judge Posner said there is jurisdiction to enter judgment for a nondischargeable debt because the proceeding is “related to” the bankruptcy case. That leaves open the question of whether the bankruptcy court has power to enter a final judgment in view of *Stern v. Marshall*.

Remanding the case, Judge Posner said there are two alternatives the bankruptcy judge “should consider.” First, the bankruptcy court could determine whether the parties consented to entry of a final money judgment, thus invoking *Executive Benefits v. Arkison*. Second, the bankruptcy judge could make proposed findings of fact and conclusions of law for review in district court.

Indeed, the parties may have already consented, either impliedly or explicitly. The creditor filed the nondischargeability suit and thus may have impliedly or even explicitly consented to entry of judgment for the debt, and the debtor may have impliedly or explicitly consented by filing the chapter 7 petition in the first place. Both raise interesting questions about consent in the wake of *Executive Benefits*.

Judge Posner’s opinion also establishes a precedent regarding appellate practice, because entering a money judgment in a dischargeability suit is ordinarily considered discretionary. Judge Posner, though, did not say whether he was remanding for abuse of discretion or commission of a legal error.

Judge Posner may have believed, without saying so directly, that doubting the bankruptcy court’s constitutional power to enter a money judgment was legal error not requiring the appellate court to find an abuse of discretion. Or, perhaps Judge Posner believes that failing even to consider entry of a money judgment in itself was an abuse of discretion.

The appeal entailed a separate issue *sub judice* in the Supreme Court involving dischargeability for actual fraud under Section 523(a)(2)(A). In *Husky v. Ritz*, the high court will decide whether there must be a misrepresentation made to the creditor to justify a finding of nondischargeability for actual fraud.

Although the Fifth Circuit in *Husky* required the existence of a misrepresentation to the creditor, a 2000 decision by Judge Posner in *McClellan v. Cantrell* did not.

In the Seventh Circuit case decided on April 5, the bankrupt arguably made a fraudulent transfer with actual intent to defraud. The creditor was unaware of the transfer, and the bankrupt had made no representation to the creditor about it.

The bankruptcy judge held that a pre-existing debt owing to the creditor was not rendered nondischargeable by the subsequent transfer with actual intent to defraud that made the debtor unable to repay the pre-existing debt.

Judge Posner also remanded the case to the bankruptcy court to await the outcome of *Husky*. If the Supreme Court reverses the Fifth Circuit and holds that a misrepresentation to the creditor is not required by Section 523(a)(2)(A), the high court will have vindicated Judge Posner's *McClellan* decision, and additional debts will become nondischargeable in the case decided this week.

The opinion is *Siragusa v. Collazo (In re Collazo)*, 817 F.3d 1047 (7th Cir. April 5, 2016).

BAPCPA didn't end all restraints on the collection of child support, Eleventh Circuit holds.

Chapter 13 Confirmation Bars Garnishment to Pay Child Support

The statutory exception to the automatic stay allowing garnishment of wages to pay a domestic support obligation ceases on confirmation of a chapter 13 plan, according to an Aug. 11 decision by the Eleventh Circuit.

A man was behind in paying his domestic support obligations, or DSOs. He confirmed a chapter 13 plan providing for the trustee to pay the arrears in full while he would directly pay future obligations in full.

To recover the arrears after confirmation, the state garnished his travel reimbursement from his employer. The bankruptcy court held the state in contempt for violating the confirmation order and assessed attorneys' fees. The district court upheld the bankruptcy court.

Sitting by designation, Circuit Judge Eugene E. Siler, Jr. of the Sixth Circuit upheld the lower courts in his opinion for the Eleventh Circuit on Aug. 11.

Judge Siler was called on to resolve an ambiguity arising from the interplay of two sections of the Bankruptcy Code, exacerbated by the 2005 BAPCPA amendments.

As amended in 2005, Section 362(b)(2)(C) creates an exception to the automatic stay that, in practical effect, now allows garnishment of post-petition income to pay DSOs after the filing of a chapter 13 petition.

Before BAPCPA, the provision only permitted attachment of property that was not property of the estate. Because post-petition income is property of a chapter 13 estate, the exception to the stay was essentially useless against a debtor in chapter 13.

The other provision at issue, Section 1327(a), makes a confirmed plan binding on creditors, whether or not they accepted or objected to the plan.

The state argued that BAPCPA was intended to remove any bar to the collection of DSOs. Judge Siler disagreed. He concluded that the exception to the automatic stay allows a DSO creditor to collect after a chapter 13 filing, "but that right ends after confirmation of the plan."

Complete freedom to collect is not necessary after confirmation, when a DSO creditor has greater protections, Judge Siler noted. DSOs are nondischargeable, and DSOs must be paid in full in a chapter 13 plan.

He said there is no legislative history to suggest that Congress intended for the BAPCPA amendment "to abrogate the binding effect of Section 1327(a)."

Judge Siler went a step further. The bar against garnishment to collect a DSO need not have been actually litigated to be covered by *res judicata*. "The binding effect of a confirmed plan encompasses all issues that could have been litigated in [the debtor's] case – including whether the [state] could intercept [the debtor's] reimbursement," he said.

The opinion is *State of Florida Dept. of Revenue v. Gonzalez (In re Gonzalez)*, 15-14804 (11th Cir. Aug. 11, 2016).

Lawyer's malpractice can satisfy
Bullock*'s recklessness standard for*
nondischargeability.

Seventh Circuit Allows Using Objective Evidence to Prove Subjective Recklessness

The Seventh Circuit expounded on the definition of "defalcation," which the appeals court said is "a word that only lawyers and judges could love."

The case allowed Circuit Judge David F. Hamilton to apply *Bullock v. BankChampaign NA*, the 2013 Supreme Court decision on Section 523(a)(4) holding there is no "defalcation" while acting in a "fiduciary capacity" unless the bankrupt had knowledge that the conduct was improper or there was gross recklessness about the improper nature of the action.

A lawyer filed bankruptcy after being socked in state court with a malpractice judgment for what Judge Hamilton called "egregious breaches of fiduciary duty." The lawyer claimed it was error to except the debt from discharge, contending that the bankruptcy judge applied an objective test.

Judge Hamilton's March 18 opinion is a scholarly exploration of "defalcation." In applying its definition to the facts of a case, he said it is permissible for the bankruptcy court to base its findings on circumstantial evidence. Although the judge could draw inferences about the lawyer's state of mind from objective circumstances, "the court applied the correct subjective standard," the opinion states.

"The bankruptcy court's finding of subjective recklessness," Judge Hamilton said, "was a reasonable finding from the circumstantial evidence."

The case is a reminder that lawyers must pay attention to ethical precepts even in small matters. As a consequence of receiving $400 for preparing documents for a real estate closing, the lawyer ended up with a $26,000 nondischargeable judgment for malpractice.

The opinion is *Estate of Stanley Cora v. Jahrling (In re Jahrling)*, 816 F.3d 921 (7th Cir. March 18, 2016).

Eighth Circuit BAP majority allows collection of disallowed priority claims.

Disallowance of Nondischargeable Debt Does Not Bar Later Collection, BAP Says

In a split decision, the Eighth Circuit Bankruptcy Appellate Panel seemingly held that the holder of a priority domestic support claim can ignore a bankruptcy court order reducing the amount of the claim and, after discharge, collect the disallowed portion of the claim without violating the discharge injunction.

The majority opinion on June 13 was written by Bankruptcy Judge Robert J. Kressel of Minneapolis. The dissenter was Bankruptcy Judge Thomas L. Saladino of Lincoln, Neb.

The opinion could be read as encouraging priority creditors to ignore bankruptcy court orders reducing or disallowing their claims. On the other hand, the opinion might be understood more narrowly to mean that the creditor was able to collect a disallowed debt only because the bankruptcy court failed to formulate its opinion and order correctly.

A man filed a chapter 13 petition, listing his former wife as the holder of a priority unsecured domestic support obligation. The Missouri Division of Child Support Enforcement initially filed an unsecured priority claim for about $36,000. Later, the Division learned that it had incorrectly calculated the monthly support obligation and filed an amended claim for more than $88,000.

The debtor objected to the amended claim. The bankruptcy court held a hearing and disallowed the $88,000 claim while allowing the claim for $36,000, ruling that the Department had waived the excess under Missouri law by acquiescing to the lower payments after the children were emancipated.

The debtor confirmed his plan, paid the entire $36,000 allowed claim over his five-year plan and got a discharge. The Department never appealed the disallowance order or the plan confirmation order, so those orders became final.

After discharge, the Department began garnishing the debtor's salary to collect the disallowed portion of the domestic support claim. The debtor filed a contempt motion in bankruptcy court.

Finding the Department in willful contempt of the discharge injunction, the bankruptcy court held that the support obligation had been paid in full and directed the Department to cease collection activities. The bankruptcy court also imposed a $1,300 sanction on the state in

compensation for the debtor's attorney's fees. The Department appealed and persuaded the majority on the BAP.

In a holding with which some may disagree, Judge Kressel for the majority said that the "discharge injunction does not apply to a nondischargeable domestic support obligation, even the disallowed portion."

The debtor argued that the doctrines of *res judicata* and collateral estoppel barred the state from contesting the amount of the claim. "While that may be true," the majority said they would not reach those theories "based on our conclusion that the Division did not violate the discharge injunction."

"Why even have a claim determination, then?," Prof. Bruce A. Markell asked after reading the majority's opinion. In a note to ABI, he mentioned how the appellate panel explicitly held, "[T]he bankruptcy court had jurisdiction to determine the Division's claim." He also noted that "the court precluded the debtor, as appellee, from raising an issue contained in the record because he hadn't raised it before the bankruptcy court. That's contrary to standard appellate practice; while appellants don't get to raise new issues on appeal, appellees usually can raise any issue found in the record that supports the judgment." Prof. Markell is the Professor of Bankruptcy Law and Practice at Northwestern Pritzker School of Law. He was a member of the Ninth Circuit BAP before he returned to teaching.

Even though the bankruptcy court had jurisdiction to fix the amount of the claim for plan purposes, the BAP majority evidently believe that the disallowed portion of the debt was a nondischargeable claim that survived bankruptcy.

The BAP majority based their holding on the notion that the bankruptcy court only ruled about contempt of the discharge injunction and did not base its decision on violation of the prior order disallowing the claim. The dissenter, Judge Saladino, criticized the majority for characterizing the debtor's motion and the bankruptcy court's order "too narrowly." He said the bankruptcy court was clearly sanctioning the Division for trying to collect a debt that was fully paid, whether it was dischargeable or not.

The majority did not discuss the Supreme Court's 2010 *Espinosa* opinion, which held that a bankruptcy court order discharging student loan debt was enforceable even though the court employed the incorrect procedure.

The BAP should consider granting rehearing at least to clarify the opinion, even if the result is the same. Did the BAP mean to say that a bankruptcy court can trim down the amount of a nondischargeable priority claim only with respect to payments under a plan, leaving the creditor free to litigate the amount of the claim again in another court after the discharge is entered? The

BAP might also explain why the bankruptcy court, if it has jurisdiction, cannot determine the amount of a priority claim with binding force.

Or, if the majority only meant to say that contempt was improper, then the BAP should consider narrowing the language in its opinion.

The opinion is *State of Missouri v. Spencer (In re Spencer)*, 550 B.R. 766 (B.A.P. 8th Cir. June 13, 2016).

Debt not resulting from 'actual fraud' is nondischargeable if fraud is grounds for veil piercing, Tenth Circuit BAP holds.

Husky Breeds a New Species of Loss of Discharge Not Benefitting All Creditors

A decision from the Tenth Circuit Bankruptcy Appellate Panel demonstrates how much this year's Supreme Court decision in *Husky International Electronics Inc. v. Ritz* expands the universe of nondischargeable debts beyond claims held by creditors who were themselves defrauded.

Now, the challenge for lower courts is to decide whether there are limits to the *Husky* doctrine, and if so, where they are.

Section 523(a)(2)(A) makes a debt nondischargeable if it was obtained by "actual fraud." In *Husky*, the Supreme Court held that a debt can be nondischargeable even if the debtor made no misrepresentation to the creditor. To read ABI's discussion of *Husky*, click here.

In the case before the Tenth Circuit BAP, a man had applied for an Oklahoma nursing home license. In the application, he represented that he would be actively involved in operations and physically present at least eight hours a month.

A patient died in the nursing home, allegedly as a result of substandard care. The surviving spouse sued the nursing home and its owner, who made the representations in obtaining the license. On the eve of trial, the owner filed personal bankruptcy. The trial went ahead only against the nursing home, which defaulted and was saddled with a $1 million judgment.

In bankruptcy court, the spouse filed a nondischargeability complaint against the owner, alleging that he was liable for the judgment under Oklahoma law that permits veil piercing "under the legal doctrine of fraud." The spouse alleged that numerous representations made to the state in the license application were false. The owner responded by filing a motion for summary judgment, relying on the fact that the judgment was based on negligence, not fraud.

Before the Supreme Court handed down *Husky*, the bankruptcy court granted the summary judgment motion and dismissed the nondischargeability complaint, because the judgment was for nothing that the owner obtained from the spouse.

The surviving spouse appealed and won in an Aug. 19 opinion authored by Bankruptcy Judge Robert H. Jacobvitz of Albuquerque, N.M., that relies heavily on *Husky*. He said "there is no requirement that the debt be for something the debtor obtains from the creditor."

As long as the debtor obtains money by "actual fraud," the BAP held that "any liability of the debtor arising from the false pretenses, fraud, representations, or actual fraud is excepted from discharge." Furthermore, nondischargeable liability is not limited by the value of the property obtained by fraud.

In addition, the opinion says "there is no requirement" under subsection (a)(2)(A) "that the debtor obtain the debt by actual fraud or that the debt is for something the debtor obtained by actual fraud."

The decision does not necessarily mean that the debt is nondischargeable. The BAP remanded the case because, among other things, there were disputed issues of fact in the surviving spouse's complaint, and the bankruptcy court needed to decide whether the debtor obtained property by "actual fraud."

Having originally held that the judgment was based on negligence, not fraud, the bankruptcy court did not reach the veil-piercing issue that turned on allegations of fraud. In that respect, the BAP distinguished the basis for the debt from the grounds for finding nondischargeability. Although the debt itself may not be based on fraud, a creditor still can prevail by showing the fraud required by subsection (a)(2)(A) in its veil-piercing theory, the BAP said.

Like in *Husky*, where the creditor needed to pierce the veil, the nondischargeability complaint ultimately will fail if the creditor cannot pierce the corporate veil under the "fraud-based corporate veil piercing claim under Oklahoma law."

At this juncture, the law after *Husky* may be pointed toward holding that anyone who commits fraud against or on behalf of a corporation can end up with nondischargeable liability for debts owing by the corporation.

In this case, like *Husky*, the alleged fraud was not peculiar to the creditor who that raised the claim. In other words, any creditor successfully raising nondischargeability will have a debt that survives, while creditors that don't will see their claims barred after bankruptcy. In effect, *Husky*-style nondischargeability is a species of loss of discharge that does not apply to all creditors.

On remand from the Supreme Court in *Husky*, the Fifth Circuit in turn remanded the case for further findings by the bankruptcy court. To read the ABI analysis of the Fifth Circuit's remand, click here.

The opinion is *Hatfield v. Thompson (In re Thompson)*, 15-027 (B.A.P. 10th Cir. Aug. 19, 2016).

Getting punched out in a bar fight might not result in a nondischargeable debt.

How the Bankruptcy Code Determines the Winner of a Bar Fight

The Sixth Circuit's Bankruptcy Appellate Panel laid down rules for deciding who wins a bar fight, and the winner in court is not necessarily the one who got his lights punched out.

The case involved a late-night altercation fueled by copious amounts of alcohol consumption. The evidence was typically conflicting, with everyone claiming to be the victim rather than the aggressor.

Although one combatant outweighed the other by 60 pounds, the larger pugilist ended up on his back, with broken facial bones caused by one punch from his smaller opponent.

The winner of the fight was arrested and pleaded *nolo contendere* to a criminal charge of assault and battery. He filed bankruptcy after being sued for damages.

The loser in the fight, who happened to be a lawyer, filed an adversary proceeding to declare that his damages from sustaining willful and malicious injuries were not dischargeable under Section 523(a)(6). After trial, the bankruptcy judge discharged the debt, concluding that the bankrupt did not inflict the injury willfully because he did not know it would cause the damage that resulted.

On appeal, the appellate panel reversed in an opinion by Bankruptcy Judge Joan A. Lloyd from Louisville, Ky. She held that the bankruptcy judge misapplied the law, although the findings of fact were unassailable under the clearly erroneous standard.

The law is clear, according to Judge Lloyd. Anyone who throws a punch automatically satisfies the willfulness requirement in Section 523(a)(6). The plaintiff need not prove that the aggressor intended to cause the resulting injury.

In a bar fight, the determinative issue instead is the "maliciousness" half of the dischargeability question. Judge Lloyd said that "self-defense can constitute a justifiable excuse for a defendant's actions and negate a claim of malice."

Remember this when contemplating a fistfight in Michigan: According to state law and the similar Restatement (Second) of Torts, someone not engaged in a crime may use non-deadly force whenever he or she "reasonably believes" that force is required to defend against "imminent unlawful use of force by another individual," even if retreat is possible. (Try going through that checklist if you are inebriated and someone is about to punch you in the kisser.)

The appellate panel reversed and remanded, directing the bankruptcy judge to apply the law of self-defense on the question of malice, with the debtor bearing the burden of proof on that issue.

Judge Lloyd said that the plea of *nolo contendere* is inadmissible in evidence under Rule 410 of the Federal Rules of Evidence.

The opinion is *Juett v. Casciano (In re Casciano)*, 15-8013, 2016 BL 5960 (B.A.P. 6th Cir. Jan. 11, 2016).

Wages & Dismissal

Question left open in* Harris v. Viegelahn *decided against debtor in chapter 11.

Courts Split on Allowing Individual Debtors to Retain Wages on Conversion from 11 to 7

The courts are split on the fate of wages earned by an individual in chapter 11 whose case converts to chapter 7. Can the debtor retain the wages, or does the money go to the chapter 7 trustee for distribution to creditors?

In *Harris v. Viegelahn*, the Supreme Court held in 2015 that an individual's undistributed earnings in the hands of a chapter 13 trustee go to the debtor when the case converts to chapter 7. Does the same rule apply when an individual's case converts from chapter 11 to chapter 7?

Disagreeing with the *Collier* bankruptcy treatise, District Judge John Z. Lee of Chicago came down the side of lower courts holding that the money is for the chapter 7 estate. Similarly, Bankruptcy Judge Robert D. Martin of Madison, Wis., gave the money to the chapter 7 trustee, saying that *Harris* answered a "narrow question" and does not "stand for the proposition that all post-petition earnings revert to a debtor when a case is converted from *any* chapter to a chapter 7."

No circuit court has decided the issue.

Several provisions in the Bankruptcy Code dance around the question, but none answers it for conversions from chapter 11 to chapter 7.

Section 1115 was amended in 2005 to provide that money earned by an individual while in chapter 11 is part of the bankrupt estate, not separate property the individual can keep regardless. On the other hand, Section 348(f)(1)(A) expressly says that earnings while in chapter 13 go to the bankrupt if the case is converted to chapter 7.

The statute is silent about conversions from chapter 11 to chapter 7.

In a 2014 decision called *Markosian v. Wu (In re Markosian),* the Ninth Circuit Bankruptcy Appellate Panel let the debtor keep the earnings, seeing no reason for treating bankrupts differently if their cases were converted from chapter 11 than if they were converted from chapter 13. The panel also cited Section 541(a)(6), which provides that money earned after filing in chapter 7 belongs to the bankrupt.

Employing the *expressio unius* doctrine of statutory interpretation, Judge Lee reached the opposite conclusion in his March 11 opinion, saying it was "significant" that Congress only dealt with conversions from chapter 13 and not from chapter 11 in amending Section 348(f)(1)(A).

Seeing chapters 13 and 11 as "replete with policy considerations," Judge Lee said that Congress "is better equipped at making these policy choices than the courts."

In his opinion on April 8, Judge Martin declined to follow *In re Markosian*. He based his decision in part on the statute's silence about conversions from chapter 11 to chapter 7. That is, there is no counterpart to Section 348(f)(1)(A) for cases converting from chapter 11. He therefore applied cases decided before *Harris*.

The opinions are *Meier v. Katz (In re Meier)*, 15-3434 (N.D. Ill. March 11, 2016), and *In re Gorniak*, 549 B.R. 721 (Bankr. W.D. Wis. April 8, 2016).

Personal loan with a profit objective becomes a business debt.

Ninth Circuit BAP Classifies a Loan for Living Expenses as a Business Debt

The Ninth Circuit Bankruptcy Appellate Panel showed its propensity once again for classifying living expenses as business debts if they are intertwined with a profit motive. On the continuum between consumer and business debts incurred by individuals, the opinion does not indicate where one begins and the other ends.

Two years ago, the appellate panel held that a home mortgage can be a business debt. In a July 22 opinion, the same court decided that money borrowed to pay ordinary living expenses also can be a business debt.

The new case revolved around Section 523(d), which allows recovery of attorneys' fees after defeating an objection to dischargeability of a "consumer debt." Section 101(8) defines "consumer debt" to mean a debt incurred "for a personal, family, or household purpose."

An author borrowed money from a friend to pay living expenses while he wrote a book. If the book sold, the lender and the author were to split the royalties. If the book did not sell, the lender could demand payment of the note, which he did.

In the author's chapter 7 case, the lender objected to dischargeability of the $150,000 debt and lost because he did not file the complaint on time. When the author sought recovery of his attorneys' fees under Section 523(d), the bankruptcy judge ruled against the author, holding that the loan was not a consumer debt.

It is settled in the Ninth Circuit, the appellate panel said in its *per curiam* opinion, that "the purpose for which the debt was incurred affects" its classification as a consumer or business debt. If "incurred for business ventures or other profit-seeking ventures," it is not a consumer debt, the panel said.

To no avail, the debtor contended that use of the borrowed money is determinative.

The panel relied on its 2014 decision in *Aspen Skiing Co. v. Cherrett (In re Cherrett)*, holding that a home mortgage was a business debt because the debtor purchased the home to take a new job in another city and hoped to make a profit on selling the home later. In *Cherrett*, the mortgage was a business debt because "it was an integral part of [the debtor's] employment."

The panel rejected the debtor's "use" test as "unworkable" because it would obviate the "court's consideration of the debtor's motive." Also, the opinion says that focusing on use would enable a debtor to "convert the character of a debt from business to consumer (and *vice versa*) by simply using the funds for a purpose different than the original purpose."

Since the purpose of the loan was to make a profit from writing and selling a book, the appellate panel held that the bankruptcy court did not commit clear error in classifying the obligation as a business debt, thus precluding the debtor from recovering attorneys' fees under Section 523(d).

If the author had obtained the same loan from a bank that would not share in royalties from the book, would the debt have been considered consumer in nature? Was the result influenced by the general American antagonism to fee-shifting, as exemplified in the bankruptcy context in *Baker Botts LLP v. ASARCO LLC*?

The opinion is *Bushkin v. Singer (In re Bushkin)*, 15-1285 (B.A.P. 9th Cir. July 22, 2016).

Debtor kicked into longer plan as a consequence of employer's expense reimbursements.

Reimbursed Expenses Included in Calculating Median Income for Plan Duration

An employer's reimbursement of a worker's business expenses must be included in calculating whether the debtor has above-median income, according to Bankruptcy Judge Beth E. Hanan of Milwaukee.

The debtor, who was not self-employed, got about $1,000 a month in reimbursement from his employer for using his personal car on business and entertaining customers. If the $1,000 were included in calculating "currently monthly income," he would have above-median income, requiring a five-year chapter 13 plan. If reimbursement were not included, he would have below-median income, making him eligible for a three-year plan.

Although there were no cases on point for a debtor not self-employed, Judge Hanan found the answer in the language of the Bankruptcy Code and by analogy to cases dealing with self-employed debtors.

Section 101(10A) defines current monthly income, or CMI, as average monthly income from all sources "without regard to whether such income is taxable income." The statute also says that CMI includes regular payments from sources other than the debtor "for the household expenses of the debtor." Social Security benefits and some other items are statutorily excluded from CMI.

While Section 1325(b)(2) defines "disposable income" as CMI less reasonable expenses, Judge Hanan said that the Code allows deductions of expenses only once, in the calculation of disposable income, "but not in the CMI calculation."

In her Sept. 29 opinion, Judge Hanan was persuaded by "analogous" cases involving self-employed debtors where, she said, a majority of courts require inclusion of gross receipts in CMI but do not permit deduction for "necessary operating expenses."

There is a "disconnect," she said, between the Official Forms and the Code itself. Although Line 5 of Form 122C-1 allows for deducting operating expenses, she said the Code is controlling because Section 101(10A) does not provide for deductions.

Based on the "plain language" of the statute and the lack of an exclusion in Section 101(10A), Judge Hanan concluded that "employer-paid reimbursements are income that must be included in the CMI calculation."

If he appeals, the debtor might argue that the statute does contain language in his favor. Under Section 101(10A)(B), CMI includes income from other sources if it is "for the household expenses of the debtor." Arguably, reimbursement from the employer is income from another source that is excluded because it is not for "household expenses."

As consolation for the debtor, Judge Hanan said that reimbursed expenses represent a deduction in determination of disposable income and the resulting payments, if any, to unsecured creditors.

The opinion is *In re Reinhart*, 16-21042 (Bankr. E.D. Wis. Sept. 29, 2016).

Plans

Appeals court narrowly reads **Bullard**
on finality.

Seventh Circuit Requires Chapter 13 Payments Beyond Five Years

The Seventh Circuit handed down a decision creating long-lasting uncertainty in the lives of chapter 13 debtors with increasing income. The June 23 opinion can result in requiring chapter 13 debtors to make payments for more than five years and gives a narrow reading to the Supreme Court's *Bullard* decision on finality of bankruptcy court orders.

The Seventh Circuit's opinion means that chapter 13 debtors cannot rely on orders denying increases in plan payments. In this case, the debtors face a potential loss of discharge even though they paid more than $40,000, having relied on the bankruptcy court's order saying they were not required to pay an extra $15,000.

The Facts

A couple confirmed a chapter 13 plan calling for payments of $670 a month, paying unsecured creditors and providing $22,000 in distributions to unsecured creditors.

About two years after confirmation, the trustee got a tax return showing that the debtors' annual income had increased $50,000 in the year following plan approval. The trustee filed a motion asking the bankruptcy court to require an increase in the monthly payments to $1,416 for the remaining two years in the plan.

In opposition, the debtors argued that their expenses also had increased.

The bankruptcy judge denied the trustee's motion, saying that the Bankruptcy Code has no provision allowing an increase in payments for the reasons given by the trustee. Even if there were power to increase payments, the bankruptcy judge said that the facts did not support the trustee's motion.

On the first appeal, the district court affirmed the bankruptcy court, finding no statutory authority to increase the payments. The district judge did not reach the question of whether the facts supported an increase.

The debtors appealed to the Seventh Circuit.

Appealability

In *Bullard*, the Supreme Court held in 2015 that denying confirmation of a chapter 13 plan is not a final order giving a right to appeal, unless the bankruptcy judge also dismisses the case. The debtors therefore contended that denial of the trustee's motion to modify the plan was not a final order giving the Seventh Circuit appellate jurisdiction under 28 U.S.C. Section 158(d)(1).

In his June 23 opinion for the circuit court, District Judge Lynn S. Adelman of Milwaukee, sitting by designation, held that denial of a plan modification motion is a final order.

He said that denial of plan modification was a final order because it was not based on a technical mistake or some other factor that could be cured by an amended motion. In other words, if denial of the motion precludes filing a new motion on the same grounds, the order is final. The circuit court's opinion endeavored to explain why the same analysis does not apply to denial of confirmation orders.

Although the opinion in this instance was anti-debtor, the finality reasoning can be helpful for debtors in other cases. If, for example, a debtor's motion to lower plan payments is denied, denial of the motion would be appealable in a circuit that follows the Seventh.

The opinion suggests that courts will read *Bullard* narrowly when convinced that the bankruptcy court made a mistake.

Mootness

The debtors next argued that the appeal was moot because it came to the circuit court after the debtors had made all payments under their five-year plan. They relied on Section 1329(c), which provides that the court may not approve a plan modification calling for payments over a period exceeding five years.

There was a live dispute, and no mootness, Judge Adelman said, because the bankruptcy court on remand could still find the debtors in default and deny their discharges.

The opinion throws the debtors a lifeline by saying that the bankruptcy court "might allow" the debtors to cure the default by paying the extra $15,000 that creditors would have received had the bankruptcy judge granted the trustee's motion initially.

Although the debtors would be making payments outside the five-year commitment period, Judge Adelman said that those payments would not be "provided for" by the modified plan, thus not bringing Section 1329(c) into play. Rather, he said, the payments would be made to cure default. In that respect, the opinion cites cases allowing chapter 13 debtors to cure payment defaults after the five-year period has expired.

The debtors next argued that the appeal was moot because Section 1329(a) provides that a plan may only be modified "before the completion of payments." Judge Adelman interpreted the section to mean, however, that the bankruptcy court may approve a modification outside the five-year period so long as the motion to modify was made within the period.

Again, the ruling on mootness can benefit debtors in other cases, for instance, if the bankruptcy court denies a motion to lower payments and an appellate court reverses after plan payments were completed. In the meantime, however, the debtors have been making payments they cannot afford, or they might have seen their case dismissed if they did not pay. And if the debtors win on appeal, must the trustee recover payments from creditors, or is the trustee personally liable? A prudent trustee might hold back the excess payments pending appeal.

The Merits

Reaching the merits, the appeals court noted how the debtors conceded that the bankruptcy court has power to increase plan payments in a proper case.

The circuit court said that Section 1329, on plan modifications, does not contain "explicit standards" for deciding when a plan can be modified. Instead, Congress "left the development of those standards to the courts." Here, the trustee sought modification because the debtors' income had increased "substantially."

In its holding on the merits, the Seventh Circuit said that a bankruptcy court has discretion to raise plan payments if "a change in the debtor's financial circumstances makes an increase in payments affordable." The appeals court preceded the holding by citing cases that permit alteration of plan payments when the debtors' financial circumstances have changed.

On Remand

Because the district court had not decided whether an increase in payments was factually warranted, the circuit court remanded, presumably for the district judge to decide whether the bankruptcy court's findings of fact were reversible.

Reversing and remanding does not necessarily mean that that the debtors will be required to pay the additional $15,000 because the holding on the merits appears to enable the debtors to argue that an increase is not "affordable."

The Debtor's Counsel

On appeal, the debtors were represented *pro bono* by former Bankruptcy Judge Eugene R. Wedoff. Retired from the bench, Judge Wedoff is taking cases without fee that raise important issues in bankruptcy law.

The opinion is *Germeraad v. Powers*, 15-3237, 2016 BL 201326 (7th Cir. June 23, 2016).

Bar to modification of a home mortgage trumps ability to cure in chapter 13.

Fourth Circuit Says Chapter 13 Can't Reinstate Non-Default Rate on Home Mortgage

In a defeat for consumers, the Fourth Circuit held that the power to "cure" does not allow a chapter 13 debtor to lower the interest rate on a home mortgage to the non-default rate.

A couple defaulted on their home mortgage before bankruptcy. The mortgage called for the interest rate to climb two percentage points after default. Also before bankruptcy, the lenders gave notice invoking the higher rate.

The debtors' chapter 13 plan called for curing the defaults within the five-year duration of the plan. The plan reinstated the contractual maturity date and provided that the interest rate on the cure payments and the regularly monthly payments would be the lower non-default rate.

The bankruptcy court sustained the lender's objections to the plan. The plan confirmed by the court required the higher default rate for all payments on the mortgage and the arrears. The debtors appealed. They lost in district court and lost again in an April 27 opinion by Circuit Judge J. Harvie Wilkinson III.

Judge Wilkinson framed the question as whether the ability to cure default under Sections 1322(b)(3) and (5) trumps Section 1322(b)(2), which precludes modifying a "claim secured only by a security interest in real property that is the debtor's principal residence." In ruling that the debtors could not reinstate the lower non-default rate, he held that subsections (3) and (5) do not undo a "residential mortgage lender's fundamental rights."

Analyzing the legislative history and the language of the statutes, Judge Wilkinson concluded that Congress drew a "clear distinction between plans that merely cure defaults and those that modify the terms of residential mortgage loans." Lowering the interest rate, he said, would modify the loan. He also said that the inability to impose default rates of interest might "motivate fewer lenders to engage in mortgage lending in the first place."

Neither the circuit court's opinion nor the debtors' briefs cited cases on the ability in chapter 13 to reinstitute the lower contract rate on a home mortgage once a default rate has been imposed before bankruptcy.

The opinion is *Anderson v. Hancock (In re Anderson)*, 820 F.3d 670 (4th Cir. April 27, 2016).

Sloppy drafting in BAPCPA puts individuals at the mercy of dominant creditors in chapter 11.

Congress Did Not Abrogate Absolute Priority for Individuals, Five Circuits Now Hold

All five courts of appeals to consider the question agree that the absolute priority rule still applies to an individual in chapter 11, despite what appeared to be an effort by Congress in 2005 to amend the statute by allowing individuals to retain property they owned before bankruptcy when cramming down a plan on a dissenting class.

On Jan. 28, the Ninth Circuit overruled its own Bankruptcy Appellate Panel's *Friedman* opinion from 2012, which had been the leading judicial authority for the proposition that the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, or BAPCPA, abrogated the absolute priority rule for individuals in chapter 11.

The decisions by the courts of appeals are a burden for owners of small businesses in chapter 11 because they give an effective veto power to a dominant creditor.

If there is one creditor with a large enough claim opposing a plan, the bankrupt is effectively barred from using cramdown to win confirmation. Consequently, the owner of a small business can be forced by one creditor with a large claim to liquidate or sell the business, even if the plan might have paid more than liquidation.

Originally engrafted by the courts onto the former Bankruptcy Act, which had been silent on the issue, the absolute priority rule was intended to prevent shareholders from receiving a distribution in chapter 11 if the plan was being crammed down on a dissenting class of creditors. When Congress codified the absolute priority rule in the 1978 Bankruptcy Code, it meant that individuals in chapter 11 using cramdown could not keep property.

To some observers, Congress intended in BAPCPA to change the rule by amending Section 1129(b)(2)(B)(ii) to create an exception to the absolute priority rule for individuals. BAPCPA at the same time added entirely new Section 1115, which brings property that was acquired after bankruptcy into the estate.

In the case before the Ninth Circuit, Bankruptcy Judge Thomas C. Holman of Sacramento, Calif., had bravely parted company with the Ninth Circuit appellate panel's *Friedman* decision by holding that absolute priority remains a condition to cramming down a plan in an individual in chapter 11. Although he held that appellate panel opinions were not binding on him, the Ninth

Circuit did not reach that issue when it overruled *Friedman*. Judge Holman authorized an appeal directly to the court of appeals.

The appeals court's opinion by Circuit Judge Andrew D. Hurwitz acknowledged a "significant split of authorities" among lower courts, although the Fourth, Fifth, Sixth and Tenth Circuits all held that BAPCPA did not change the law. Those circuits rejected the broad view adopted by *Friedman* and several other lower courts that Congress intended in BAPCPA to abrogate absolute priority for individuals in chapter 11.

Judge Hurwitz followed what he called the narrow view, where courts interpret BAPCPA's amendments to mean that an individual cannot cram down a plan on a dissenting class and retain pre-petition property of the estate. The amendments, he said, only allow an individual debtor to keep property acquired post-petition when cramming down a plan.

In substance, Judge Hurwitz and the other courts of appeals believe that Section 1115 put pre-petition property back that Section 1129(b)(2)(B)(ii) had taken out. Some commentators believe that BAPCPA includes a scrivener's error that has an opposite effect from what Congress intended.

The Ninth Circuit conceded that the narrow view works a "double whammy" because an individual debtor must use post-petition income to pay creditors' claims under the plan, while pre-petition property must also go to creditors. If Congress had intended to abrogate absolute priority for individuals, Judge Hurwitz said it could have done so "in a far more straightforward manner." To overrule a judicially created concept, he said, Congress must make its intent "specific."

The opinion is *Zachary v. California Bank & Trust (In re Zachary)*, 811 F.3d 1191 (9th Cir. Jan. 28, 2016).

Ninth Circuit BAP and Third Circuit duke it out over Section 1123(b)(5).

Courts Split on Stripping Down Residential Mortgages in Chapter 11

Courts are split on whether an individual chapter 11 debtor can strip down a home mortgage when the property is used in part to generate income.

At issue is Section 1123(b)(5), which provides that a plan may strip down a secured claim, but not "a claim secured only by a security interest in real property that is the debtor's principal residence."

Interpreting that section pits the Third Circuit on one side of the answer and the Ninth Circuit Bankruptcy Appellate Panel on the other. District Judge Richard Seeborg of San Francisco had to decide which court had the better answer. He sided with his circuit's appellate panel on one issue in the case and with the Third Circuit on another.

In a 2006 case called *Scarborough*, the Third Circuit concluded that "only" defines both "security interest" and "principal residence." In other words, a debtor could strip down a mortgage if the property was secured only by a lien on real property and only if the property was the principal residence.

The Ninth Circuit BAP reached the opposite conclusion in 2014 in *In re Wages*. The panel held that plain meaning bars bifurcation even if the property is used for more than just the debtor's principal residence.

Judge Seeborg adopted the appellate panel's *Wages* approach, holding that "only" defines only "security interest," not also "principal residence." He thus held that a debtor cannot bifurcate a home mortgage even if the property has a dual use.

The judge nonetheless declined to follow the appellate panel on the second issue in the case: whether the bar to bifurcation applies when the lien covers personal property as well as real property.

In the case at bar, the mortgage was a construction loan with liens on the real property as well as on virtually all personal property on the premises. In *In re Lee*, the Ninth Circuit BAP had held in 2007 that the bar to bifurcation applies if the lender also has a lien on personal property of "little independent value."

Following what he saw as the statute's plain language, Judge Seeborg parted company with the appellate panel, this time following the Third Circuit's 1994 *Hammond* opinion allowing modification of a mortgage also secured by personal property like machinery and equipment.

The opinion is *Utzman v. SunTrust Mortgage Inc.*, 15-cv-4299 (N.D. Cal. March 1, 2016).

Surrender & Forced Vesting

Debtors may face sanctions for continuing to occupy property they intend to surrender.

Election to 'Surrender' Property Bars Opposition to Foreclosure, Eleventh Circuit Holds

The Eleventh Circuit resolved a split among the Florida bankruptcy judges by ruling that a debtor who elects to "surrender" real property cannot oppose foreclosure. The opinion also implies that a debtor must give up possession and not force the lender to initiate eviction proceedings.

A husband and wife filed a "no asset" chapter 7 petition where they listed the mortgage on their home as valid, with mortgage debt exceeding the value of the home. They filed a statement of intention under Section 521(a)(2) to surrender the home. Since there was no equity, the trustee abandoned the home to the debtors.

The debtors opposed the lender's foreclosure. Rather than litigate in the foreclosure court, the lender persuaded the bankruptcy judge to enjoin the debtors from opposing foreclosure. The bankruptcy judge also threatened to revoke the debtors' discharges were they to persist. The district court affirmed.

The Eleventh Circuit affirmed in an opinion on Oct. 4 by Circuit Judge William Pryor.

Section 521(a)(2)(A) requires debtors to state their intention to retain, surrender or redeem property, or reaffirm the debt. Subsection (a)(2)(B) requires a debtor to "perform his intention" within 30 days.

Interpreting the "text and the context of the statute," Judge Pryor said the debtors must surrender the property to both the trustee and to the lender. If the trustee abandons the property, the debtor, he said, retains a duty to surrender the home to the lender.

Next, Judge Pryor decided what "surrender" means. It does not mean deliver possession, he said, because the Bankruptcy Code says "deliver" not "surrender" when the statute compels turning over possession.

The "context" of Section 521(a) shows that "surrender" means to give up a right or claim, according to Judge Pryor. The statutory language therefore means that debtors cannot oppose foreclosure.

Since the debtors conceded in their filings that the mortgage was valid and the lender had the right to foreclose, Judge Pryor said that enjoining them from opposing foreclosure was proper because they must "honor that declaration."

The debtors also contended that the lender's only remedy in bankruptcy court was to lift the stay and litigate in the foreclosure court.

Again, Judge Pryor agreed with the lender. He said the bankruptcy court has "broad powers" under Section 105(a) to remedy a violation of a debtor's duties under Section 521(a).

The very first paragraph of the opinion says that an election to surrender means that "debtors relinquish their rights to possess the property." The statement could be read to mean that debtors face sanctions if they force the lender to initiate eviction proceedings, even if they do not oppose foreclosure.

It remains to be seen whether the result will be the same if the facts are altered.

Suppose that the debtor states an intention to surrender, but *only to the trustee*, while listing the mortgage debt as disputed and scheduling a claim against the lender for an alleged defect in the loan or mortgage. Assuming the trustee abandons both the home itself and the claim against the lender, the debtor would not face the estoppel argument that underlay part of Judge Pryor's opinion.

On the other hand, Judge Pryor interpreted "surrender" not to mean "deliver possession." However, Judge Pryor's affirmation of the powers of the bankruptcy court implies an ability to impose sanctions on debtors who do not voluntary surrender possession.

In Florida, Bankruptcy Judges Paul G. Hyman Jr., Eric P. Kimball and Michael G. Williamson held that a statement of intention to surrender a home bars a debtor from opposing foreclosure. District Judge Kenneth A. Marra in West Palm Beach upheld Judge Hyman in *Failla.* In February, Bankruptcy Judge Laurel M. Isicoff of Miami ruled in *In re Elkouby* that a statement of intention to surrender a home does not compel a chapter 7 debtor to withdraw defenses to foreclosure.

To read ABI's write-up of the *Failla* decision in district court, click here. To read about *Elkouby*, click here.

The opinion is *Failla v. Citibank NA (In re Failla)*, 15-15626 (11th Cir. Oct. 4, 2016).

Gutsy Judge Laurel Isicoff disagrees with district and bankruptcy judges in her district.

Bankruptcy Court Said Surrender Didn't Waive Defenses to Foreclosure

[This decision was functionally reversed by the Eleventh Circuit's decision in *Failla v. Citibank NA (In re Failla)*, discussed in the preceding item. Judge Isicoff's logic could be employed by someone hoping to achieve a different result in another circuit.]

Disagreeing with bankruptcy and district judges in Florida, Bankruptcy Judge Laurel M. Isicoff of Miami ruled that a statement of intention to surrender a home does not compel a chapter 7 debtor to withdraw defenses to foreclosure.

As Judge Isicoff said in her Feb. 29 opinion, there is "an ongoing debate about the meaning of 'surrender' and what the consequences of surrender are."

Like similar cases in Florida and elsewhere, the chapter 7 debtor filed a timely statement of intention to surrender his home under Section 521(a)(2). He did not schedule the mortgage debt as disputed. He got his discharge, but the trustee did not "administer" the home, so it was automatically "abandoned to the debtor" under Section 554(c).

The lender sought and obtained a modification of the automatic stay, but the debtor took discovery and submitted defenses in the foreclosure proceeding. The lender filed a motion to reopen the bankruptcy case and compel the debtor to drop defenses to foreclosure. Judge Isicoff declined to reopen the case and denied the motion to compel.

In Florida, Bankruptcy Judges Paul G. Hyman Jr., Eric P. Kimball and Michael G. Williamson have held that a statement of intention to surrender a home bars a debtor from opposing foreclosure. District Judge Kenneth A. Marra in West Palm Beach upheld Judge Hyman in *Failla v. CitiBank NA.* To read ABI's write-up on *Failla*, click here.

Judge Isicoff said that District Judge Marra "did not cite to any Bankruptcy Code section" for his conclusion that a statement of intention to surrender abandons any interest in property or claim against the lender.

She also said that the Code nowhere says that property surrendered by a debtor is surrendered to the lender. Rather, she said, the debtor surrenders the property to the trustee, and the trustee abandons the property to the debtor if it is not administered.

Judge Isicoff pointed out how the Code gives recourse to the lenders, such as moving to modify the stay or compel the trustee to abandon the home. "What the Bankruptcy Code does not allow," she said, is for the lienholder "to wait three years or even three months, and then come back to the bankruptcy court and seek relief to which it is not entitled."

Near the end of her opinion, Judge Isicoff said that the discharge of personal liability does not "dictate a punitive response if the right to surrendered property reverts" to the debtor. If there is to be a change in the law, she said, it's "up to Congress, not the courts."

The opinion is *In re Elkouby*, 14-23934, 2016 WL 798177 (Bankr. S.D. Fla. Feb. 29, 2016).

Split in lower courts now tilts toward precluding forced title vesting in chapter 13.

New York District Court Bars Forced Vesting of Title Through a Chapter 13 Plan

Lower courts are split on the question of whether a chapter 13 plan can force a lender to take title to real property.

Reversing the bankruptcy court, District Judge Arthur D. Spatt of Central Islip, N.Y., followed what he saw as the "clear weight of authority" and held that a chapter 13 plan cannot convey title to a lender absent the lender's consent.

The issue brings two chapter 13 provisions into play. As one of the alternatives for dealing with a secured claim, Section 1325(a)(5)(C) allows the debtor to surrender property to the lender. Section 1322(b)(9) provides that a plan "may" vest title to property of the estate. Judge Spatt rested his decision in part on the notion that the vesting of title under Section 1322(b)(9) is permissive, not mandatory, while employing one of the three alternatives in Section 1325(a)(5) is mandatory.

Judge Spatt's April 12 opinion contains a valuable survey of all decisions throughout the country coming down on both sides of the question. He noted that two bankruptcy judges in Manhattan held that a plan may not force a lender into taking title.

A lender's rights include the right not to take title, or refrain from foreclosing, Judge Spatt said. He saw "no principled basis for exalting" the debtor's right to a fresh start over the "well-settled property rights of secured lenders."

He also said that the right of a lender to "control its own remedies" cannot be "subordinated to the debtors' interest in achieving a fresh start in bankruptcy."

There would be "irreconcilable legal implications," the judge said, if a plan both surrendered and vested title over a lender's objection.

The opinion is *HSBC Bank USA NA v. Zair*, 15-4958 (E.D.N.Y. April 12, 2016).

Rochelle's Daily Wire

Massachusetts judges disagree on
'forced vesting' in chapter 13 plan.

Lenders Win Again, Beating Back Forced Vesting of Title Through Chapter 13

Bankruptcy Judges Melvin S. Hoffman and Henry J. Boroff, both from Massachusetts, disagree on forcing a mortgage-holder to take title to property under a chapter 13 plan.

Last year, Judge Hoffman held that the chapter 13 plan in a case called *Sagendorph* could force a lender to take title. Otherwise, the debtor would be stuck with nondischarged post-petition costs for maintaining and insuring the property until the lender forecloses.

Judge Boroff reached the opposite result in an opinion on Jan. 13 and refused to confirm a plan calling for so-called forced vesting. He listed lower court decisions from around the country reaching different results on the issue.

Previously, Judge Boroff held that Section 1325(a)(5), which lists mandatory plan provisions, bars forced vesting unless a lender consents. He held in the new case that Section 1322(a)(9)'s optional provisions do not change the result, even though he was sympathetic to the plight of communities suffering from a blight of abandoned homes.

The opinion is *In re Weller*, 548 B.R. 392 (D. Mass. Jan. 13, 2016).

Exemptions

Exemption value to be decided at a 'one-shot' public auction.

Judge Ameliorates Louisiana's Stingy 'All or Nothing' Exemption for Wedding Rings

A bankruptcy judge in Louisiana put the screws to the trustee to ameliorate the state's stingy exemption for wedding rings.

A woman filed a chapter 7 petition three months after she married. Her husband had given her a 2.15 carat diamond engagement ring that he purchased for $9,800. At the time of purchase, the jeweler appraised the ring at $11,500.

Louisiana requires its citizens to use state exemptions. For wedding and engagement rings, the statute exempts any ring "provided the value of the ring does not exceed five thousand dollars."

The debtor scheduled the ring as worth $9,800 and claimed a $5,000 exemption. In his Aug. 31 opinion, Bankruptcy Judge Jeffrey P. Norman of Shreveport concluded that state exemption was "all or nothing," considering the plain language of the statute. In other words, if the ring were worth $5,000 or less, it would be entirely exempt. If the value were $5,001 or more, there would be no exemption at all.

Judge Norman only conditionally sustained the trustee's objection to the claimed exemption, because there was a dispute about value. For exemption purposes, the debtor argued that the ring was worth only $4,800, the amount a pawnbroker was willing to pay.

With value disputed, Judge Norman gave the trustee one shot at proving value at public auction. If the hammer price were more than $5,000, the ring would lose its exemption. If the auction price were $5,000 or less, he would direct the trustee to return the ring to the debtor.

The opinion is *In re McCollum*, 16-10904 (Bankr. W.D. La. Aug. 31, 2016).

Arizona debtors are stuck with the homestead claimed on the filing date.

Debtor Left Homeless by Inability to Alter Her Homestead Exemption Claim

At least in Arizona, a debtor cannot change her homestead exemption if the house where she resided at the time of filing is foreclosed.

The debtor owned a house that she rented on the filing date of her chapter 13 petition, later converted to chapter 7. At filing, she claimed a homestead exemption where she resided. She did not have title to the residence because it had been sold in a trustee's sale.

When the debtor was unable to set aside the trustee's sale, she filed amended schedules claiming a homestead exemption in the home she rented. According to the debtor's brief, she had moved into the home that had been rented. The bankruptcy judge nevertheless sustained an objection to the amended exemption and was upheld on Aug. 5 by District Judge Stephen M. McNamee of Phoenix.

There were two competing principles, Judge McNamee said. On the one hand, Bankruptcy Rule 1009(a) arguably grants an absolute right to revise exemption claims because the rule says that schedules "may be amended by the debtor as a matter of course at any time before the case is closed."

On the other hand, the Supreme Court created the so-called snapshot rule providing that exemptions are fixed at the time of filing.

Arizona law also comes into play by allowing a homestead exemption in one "dwelling house in which the person resides."

Taking these factors into consideration, Judge McNamee upheld disallowance of the amended exemption because the debtor could not have claimed the exemption at the filing date. He interpreted Arizona law to mean that an initially claimed exemption "will persist through the remainder of the bankruptcy proceeding regardless of subsequent developments."

It is unclear whether the conclusion would be the same in other states with differently worded exemption statutes.

The opinion does not discuss whether the Supreme Court impliedly modified the snapshot rule by approving Bankruptcy Rule 1009.

The decision has little discussion of the implications of Arizona law allowing a homeowner to sell a homestead and continue the exemption by purchasing a new home within 18 months. Although the opinion mentions the subject, there is also little discussion of the principle that homestead exemptions are to be liberally construed.

The opinion is *Earl v. Lund Cadillac LLC*, 15-1693 (D. Ariz. Aug. 5, 2016).

Late-Filed Tax Returns

Eleventh Circuit keeps taxpayer on the hook for late-filed tax returns.

Circuit Splits Widen on Dischargeability of Tax Debts on Late-Filed Returns

The Eleventh Circuit charted a different course from three other circuits in holding that the debt shown on a late-filed tax return is not dischargeable under Section 523(a)(1)(B)(i) and the so-called hanging paragraph added by Congress along with the 2005 amendments.

Three circuits — the First, Fifth and Tenth — ended up with what's been called the one-day-late rule: If a return is filed even one day late, the underlying debt can never be discharged, employing a complicated application of case law, several federal statutes and the Bankruptcy Code. It has been said by commentators such as Prof. Ronald J. Mann from Columbia Law School that even the Internal Revenue Service will not support that interpretation.

In a March 30 decision by Circuit Judge R. Lanier Anderson, the Eleventh Circuit held a tax debt nondischargeable using a different theory.

In this case, the debtor did not file tax returns for the years 2000 through 2003. The IRS gave notice of deficiency and assessed taxes in 2006. The taxpayer filed tax returns for those years in 2007, followed by a chapter 7 petition in 2011. The bankruptcy judge held that the tax debt was nondischargeable, and the district court agreed on appeal.

Assuming without deciding that the one-day-late rule is wrong, Judge Anderson used a different approach that still kept the debtor on the hook for the tax debt.

Judge Anderson invoked the four-part test resulting from a 1984 Tax Court decision known as *Beard*. His opinion focused on the fourth *Beard* test: Was there an honest and reasonable attempt to satisfy the requirements of tax law?

On that question, there is a split of circuits. The Eleventh Circuit chose to follow the majority, which requires "analysis of the entire time frame relevant to the taxpayer's actions." A minority of one, the Eighth Circuit held that "honesty" should be determined exclusively from the face of the tax return. In a dissenting opinion in the Seventh Circuit, Circuit Judge Frank Easterbrook saw the law as the Eighth Circuit did.

In following the majority, Judge Anderson relied on the notion that our tax system depends upon "honest self-reporting."

Although declining to adopt a *per se* rule, Judge Anderson held that there is no "honest and reasonable effort" to comply with tax law when the taxpayer files a return "years late, without any justification at all, and only after the IRS has issued notices of deficiency and has assessed his tax liability."

The opinion does not hint as to whether a tax claim could be discharged if, for instance, the debtor filed a late return before the IRS levied an assessment. In that case, the Eleventh Circuit might have to decide whether three circuits made good or bad law with the one-day-late test.

The opinion is *Justice v. U.S. (In re Justice)*, 817 F.3d 738 (11th Cir. March 30, 2016).

Rochelle's Daily Wire

Ninth Circuit avoids the one-day-late rule for nondischargeability of tax debts.

Circuit Split Widens on Test for Nondischargeability from Late-Filed Tax Returns

The Ninth Circuit entered the fray on the question of whether a debtor can discharge a tax debt when the return was filed late. The San Francisco-based court puts itself in the faction where a debtor at least has a glimmer of hope about discharging the debt shown in a late-filed return.

The courts of appeals fall into two camps. The First, Fifth and Tenth Circuits employ the one-day-late rule: If a return is filed even one day late, the underlying debt can never be discharged, employing a complicated application of case law, several federal statutes and the Bankruptcy Code.

The Fourth, Sixth, Seventh, Eighth and Eleventh Circuits follow the four-part test resulting from a 1984 Tax Court decision known as *Beard*. Courts invoking the *Beard* test ordinarily focus on the fourth factor: Was there an honest and reasonable attempt to satisfy the requirements of tax law?

Among those circuits, all but the Eighth analyze all the surrounding facts to decide the "honesty" factor. A minority of one, the Eighth Circuit held that "honesty" should be determined exclusively from the face of the tax return. In a dissenting opinion in the Seventh Circuit, Circuit Judge Frank Easterbrook saw the law as the Eighth Circuit did.

In its decision on July 13, the Ninth Circuit embraced the *Beard* test while rejecting the Eighth Circuit's approach of analyzing only the face of the late-filed return. Columbia University Law Professor Ronald J. Mann told ABI in a message that the opinion "is another court of appeals applying a multi-factor test with no obvious relation to the language of the statute."

The Ninth Circuit's case involved a man who did not file a 2001 tax return. Using information from third parties, the Internal Revenue Service issued a $70,700 deficiency notice in 2006. Three years later, the taxpayer filed a Form 1041 for 2001 showing a larger tax liability. The IRS added the additional tax to the deficiency.

After he filed bankruptcy, the taxpayer persuaded the bankruptcy court to rule that the taxes were dischargeable. The district court reversed and was upheld in the opinion by Circuit Judge Morgan Christen.

Judge Christen held that the return, filed eight years late and three years after the IRS's deficiency notice, "was not an honest and reasonable attempt to comply with the tax code." She added that "many of our sister circuits have held that post-assessment tax filings are not 'honest and reasonable' attempts to comply and therefore are not 'returns' at all."

"Because the court views this taxpayer's behavior as so reprehensible, the decision doesn't do much to clarify the law about 'returns,'" Prof. Mann said. "It specifically declines to address the government's bright-line rule that nothing filed after an assessment can qualify as a 'return.'" The professor added that "it doesn't even mention the idea, accepted by some courts, that the reference to 'filing requirements' in the definition of 'return' means that no late filing can qualify as a return."

Prof. Mann attempted to take the Tenth Circuit's one-day-late case to the Supreme Court in 2015. The high court denied *certiorari*. Prof. Mann said that the circuit court had "ruled against the taxpayer on a ground that the Internal Revenue Service won't defend." There is little prospect of Supreme Court review, he said, "until a taxpayer wins one of these cases in the courts of appeals."

Regardless of the approach a court employs, the issue regarding dischargeability of tax in connection with a late-filed return turns on Section 523(a)(1)(B)(i) and the so-called hanging paragraph added by Congress along with the 2005 amendments.

The Ninth Circuit's opinion is a vindication for the Ninth Circuit Appellate Panel's December decision in *U.S. v. Martin (In re Martin)*. There, the BAP rejected the one-day-late rule by holding that the hanging paragraph did not alter two Ninth Circuit cases that adopted a version of the *Beard* test, which defines the term "return" in the context of determining nondischargeability of tax debts.

In *Martin*, the BAP reversed and remanded for the bankruptcy judge to apply the Ninth Circuit's modified *Beard* test, which inquires into whether the document purports to be a return that was signed under penalty of perjury, contained sufficient information to allow calculation of the tax, and was an "honest and reasonable" attempt to satisfy the requirements of tax law.

To read ABI's discussion of *Martin*, click here.

Before the Ninth Circuit's opinion, the most recent circuit court decision came from the Eleventh Circuit in March in *Justice v. U.S. (In re Justice)*. To read ABI's discussion of *Justice*, click here.

The opinion is *Smith v. I.R.S. (In re Smith)*, 14-15857, 2016 BL 224521 (9th Cir. July 13, 2016).

Gutsy Ninth Circuit BAP importunes the Supreme Court to rule on late-filed tax returns.

Ninth Circuit BAP Splits with Three Circuits on Dischargeability of Tax Debts

The Ninth Circuit Bankruptcy Appellate Panel is trying to foment a split of circuits so the Supreme Court can decide whether a tax debt can never be discharged if the return is filed even one minute after the deadline.

So far, the Fifth, First and Tenth Circuits have all employed what Bankruptcy Judge Frank L. Kurtz, in his opinion for the Ninth Circuit appellate panel, called a literal construction of the so-called hanging paragraph added by Congress to the end of Section 523(a) in the 2005 BAPCPA amendments. In his Dec. 17 opinion, Judge Kurtz called it the "unforgiving view of congressional intent," because someone who files a late tax return can never discharge the underlying debt.

Columbia University Law Professor Ronald J. Mann attempted to take the Tenth Circuit case to the Supreme Court in 2015. The high court denied *certiorari*. Prof. Mann said that the circuit courts "ruled against the taxpayers on a ground that the Internal Revenue Service won't defend."

"Every appellate court to consider the question after BAPCPA has adopted the bright-line rule that no late filing ever can be a return," Prof. Mann told ABI. Judge Kurtz's opinion, he said, "provides a roadmap for the Ninth Circuit to reject that growing consensus. And that, in turn, would make the likelihood of Supreme Court review almost certain."

Judge Kurtz's opinion meticulously picks apart the shortcomings inherent in literal interpretation. He concludes that the hanging paragraph did not alter the two Ninth Circuit cases that adopted a version of the *Beard* test, which defines the term "return" in the context of determining nondischargeability of tax debts.

The literal approach, he said, would bar a debtor from discharging a tax debt if the return were filed even a minute late, "whereas a debtor taxpayer who never bothers to file his or her own tax return can discharge his or her associated tax debt if the IRS fortuitously prepares a tax return on that person's behalf." Judge Kurtz also points out how the IRS itself does not follow the literalist interpretation.

Judge Kurtz reversed and remanded the case for the bankruptcy judge to apply the Ninth Circuit's modified *Beard* test, which inquires into whether the document purports to be a return that was signed under penalty of perjury, contained sufficient information to allow calculation of the tax, and was an "honest and reasonable" attempt to satisfy the requirements of tax law.

It is unclear whether Judge Kurtz's opinion is an appealable final order, because he remanded for the bankruptcy judge to perform more than ministerial functions.

The circuit court cases are *Fahey v. Massachusetts Department of Revenue (In re Fahey)*, 779 F.3d 1 (1st Cir. 2015); *In re Mallo*, 774 F.3d 1321 (10th Cir. 2014); and *McCoy v. Mississippi State Tax Commission (In re McCoy)*, 666 F.3d 924 (5th Cir. 2012).

The Ninth Circuit appellate panel opinion is *U.S. v. Martin (In re Martin)*, 542 B.R. 479 BAP 9th Cir. Dec. 17, 2015).

Automatic Stay

For serial filers, automatic stay held to terminate only on the debtor's property.

Alabama Judge Takes Majority View on Automatic Stay Termination for Repeat Filers

The split among the lower courts widens on the automatic termination of the automatic stay as to property of the estate belonging to a repeat filer.

In the case of an individual whose prior bankruptcy was dismissed within a year of a new filing, Section 362(c)(3)(A) automatically terminates the stay in 30 days "with respect to the debtor." District Judge William R. Sawyer of Montgomery, Ala., took sides with the majority by holding that the stay does not also terminate automatically with regard to estate property.

Judge Sawyer's Aug. 25 opinion admirably lays out and analyzes decisions going both ways. No circuit court has tackled the question, but three district courts and the First Circuit Bankruptcy Appellate Panel are in the majority by holding that the stay evaporates automatically only with respect to property of the debtor.

Led by the Ninth Circuit BAP's opinion in *In re Reswick*, the minority find the statute ambiguous and hold that the stay terminates as to both the estate's and the debtor's property.

Although he followed the majority, Judge Sawyer conceded that terminating the stay only with regard to the debtor's property makes the statute "relatively toothless" against repeat filers. In practical effect, a repeat filer can be evicted under the majority's opinions, but can retain an automobile that is property of the estate.

In an opinion that is debtor-friendly in substance, Judge Sawyer said that the plain meaning of the statute is "unambiguous but not absurd." He therefore declined to correct what may have been a drafting error by Congress.

To read ABI's analysis of *Vitalich v. Bank of New York Mellon*, where a district judge in the Northern District of California took sides with the minority earlier this month, click here.

The opinion is *In re Roach*, 16-10574, (M.D. Ala. Aug. 25, 2016).

ROCHELLE'S DAILY WIRE

District judge follows Ninth Circuit BAP on stay termination for serial filers.

California Judge Adopts Minority View on Automatic Termination of the Stay

Adopting the minority view, a district judge in California decided that the automatic stay terminates automatically in 30 days as to the debtor and property of the estate, not just with respect to an individual whose prior bankruptcy was dismissed within a year.

District Judge Beth Labson Freeman of San Jose followed a 2011 Ninth Circuit Bankruptcy Appellate Panel opinion named *In re Reswick*, which she called "lengthy and well-reasoned."

In the case of an individual whose prior bankruptcy was dismissed within a year of a new filing, Section 362(c)(3)(A) automatically terminates the stay in 30 days "with respect to the debtor."

According to Judge Freeman's Aug. 10 opinion, the majority of courts hold that the stay does not terminate automatically as to property of the estate. The majority, she said, draws an "unambiguous distinction between the debtor and the debtor's property."

The minority, including the Ninth Circuit BAP, believe the majority's "plain meaning" argument is "reasonable," but they see "other reasonable constructions," Judge Freeman said. Given several possible interpretations, she concluded that the "plain meaning approach" does not answer the question.

Judge Freeman analyzed the 2005 BAPCPA amendments in Section 362 and the intention of Congress "to correct perceived abuses of the bankruptcy system." She said it would be "inconsistent with this scheme of deterrence" if the stay with regard to a serial filer remained in effect with regard to estate property, "which as a practical matter usually consists of all significant assets."

Judge Freeman therefore upheld the bankruptcy court which had ruled that the stay terminated automatically as to estate property as well.

The opinion is *Vitalich v. Bank of New York Mellon*, 16-0420 (N.D. Cal. Aug. 10, 2016).

Prepaid Fees, Claims & Eligibility

Ninth Circuit BAP highlights discrimination against chapter 7 debtors.

Chapter 7 Debtors' Access to Counsel Threatened by BAP Opinion

The Ninth Circuit Bankruptcy Appellate Panel handed down an opinion possibly meaning that debtors in Arizona, and perhaps elsewhere, cannot pay for post-petition legal services before they file chapter 7 petitions. If the decision is taken to its logical conclusion, consumer debtors in the Ninth Circuit cannot rely on having lawyers to defend objections to discharge or dischargeability and to provide other services after filing.

The BAP could be faulted for misinterpreting a 1998 Ninth Circuit opinion called *In re Hines*.

Rather than drawing a roadmap for trustees to recover retainers, the appeals court in *Hines* went out on a limb by creating a judge-made exception to the automatic stay, thereby enabling some chapter 7 debtors to prepay post-petition legal services. The result in the BAP was the opposite of what the Ninth Circuit aimed to accomplish in *Hines*.

The Facts

When a man filed his chapter 7 petition, a bank was suing him in state court, seeking $3.6 million in damages for fraud. The bank had told him it would challenge the dischargeability of the debt were he to file bankruptcy.

Before filing, the man paid a law firm a $60,000 flat fee to cover all services in connection with dischargeability litigation. The retainer agreement provided that the $60,000 would immediately become the law firm's property and would go into the firm's general business account, not an escrow account.

The bank made good on its threat and filed a dischargeability complaint four days after the chapter 7 filing. Six months later, the chapter 7 trustee sued the law firm, contending that the retainer agreement was an executory contract that was automatically rejected under Section 365(d)(1). The trustee demanded that the law firm turn over the $60,000 retainer.

Protecting the debtor's ability to mount a defense to the bank, the bankruptcy judge dismissed the trustee's complaint after ruling that the retainer agreement was not an executory contract. The trustee appealed to the BAP and won in an opinion on June 9 by Bankruptcy Judge Frank L. Kurtz, relying in large part on *Hines*.

The Appellate Panel's Opinion

The appellate panel focused on language in *Hines* that said, in the context of prepaid fees, that "the trustee can liquidate the debtor's right to legal services by rejecting the contract with the attorney and demanding a refund of the unearned fees."

Applying the so-called Countryman test, the BAP said that the law firm was required to defend while the debtor remained obligated to pay the law firm's out-of-pocket expenses. Consequently, the BAP held that the agreement remained executory because both sides still had substantial unperformed obligations.

To decide how much in fees the firm was obliged to return, the BAP said the record was inadequate because the bankruptcy judge had not decided when the trustee gave notice of termination to the law firm.

The appellate panel remanded the case to determine when the trustee gave notice of termination so the bankruptcy judge could decide whether the trustee "was entitled to any fee refund based on the value of services provided before termination."

Scholarly Commentary

"This decision puts the debtor in a very tough position," Prof. Nancy Rapoport told ABI. According to a message that Prof. Bruce A. Markell sent to ABI, "it seems that Arizona debtors won't be able to pay prepetition for any possible nondischargeability litigation. That raises real problems."

In light of the BAP opinion, Prof. Rapoport asked, "What, then, is the best way for the debtor to pay for a defense in an adversary proceeding?"

The answers to the problems identified by the two professors are not immediately apparent, unless the appellate panel misinterpreted *Hines*, or unless there is no answer absent an amendment to the Bankruptcy Code.

Prof. Rapoport is a professor at the Univ. of Nevada at Las Vegas William S. Boyd School of Law, where she is an expert on legal ethics. Prof. Markell is the Professor of Bankruptcy Law and Practice at Northwestern Univ. Pritzker School of Law. He was a member of the Ninth Circuit BAP before he returned to teaching.

What the Opinion Means

The debtor in the BAP appeal might come out relatively unscathed if the law firm had already performed most of the services in the dischargeability litigation. Other chapter 7 debtors might not be so lucky, especially if trustees begin automatically sending termination notices to consumers' attorneys immediately after the petitions are filed.

Assuming the BAP correctly interpreted *Hines*, the trustee could have recovered almost all of the $60,000 had the trustee given notice of termination immediately after the trustee was appointed. The $60,000 would have gone into the estate, leaving the debtor required to pay defense costs out of post-filing income. Although the debtor ultimately might win back some of the $60,000 by claiming exemptions, the allowed exemptions would likely represent only a fraction of defense costs, and the debtor probably would not receive a distribution on account of his exemptions in time to pay legal fees.

The BAP's opinion discriminates against chapter 7 debtors because individual debtors in chapters 13 and 11 can pay their attorneys from their plans or through interim allowances by using property of the estate that otherwise would go to creditors.

Who Is to Blame?

Blame for the predicament of chapter 7 debtors could be laid at the doorstep of the Countryman definition of executory contracts and its focus on remaining duties. Perhaps the Countryman definition does not work when one side's remaining duties are miniscule compared to the other's unperformed obligations.

The Ninth Circuit is hardly to blame for chapter 7 debtors' dilemma. In the first paragraph of *Hines*, the appeals court identified the very same problem in personal bankruptcies when the court said that the status of "postpetition services does not fit comfortably within the provisions of the Bankruptcy Code." The court went on to say that "Congress has been delinquent in failing to deal expressly with the always-present problem of arranging in advance for payment of services to be rendered after the filing in bankruptcy."

To secure payment of fees before filing, the circuit court said that chapter 7 debtors' counsel use two constructs, but both "are potentially subject to disruption by the operation of the Code."

In *Hines*, the Ninth Circuit recognized that chapter 7 debtors must have a legally enforceable mechanism to prepay for legal services, otherwise, the court said, there could be a "massive breakdown" in the "entire system."

The Ninth Circuit therefore came up with a judge-made exception to the automatic stay to solve the problem in *Hines*. That solution, however, does not suit the needs for this year's case in the BAP

Taking a cue from *Hines*, the BAP should have felt at liberty under *Hines* to adopt a construct allowing prepayment for post-petition services.

As the concurring judge said in *Hines*, Congress, rather than the courts, should level the playing field. Otherwise, the right to file bankruptcy can become illusory.

Taken to its logical conclusion, the BAP opinion is heading in the direction of allowing chapter 7 debtors only to pay counsel in advance for services to be performed before filing. The right to discharge debts will mean little if chapter 7 debtors cannot afford lawyers. Likewise, chapter 7 trustees could compel repayment of fees intended for ordinary post-petition services such as attending creditors' meetings and filing amended schedules and statements.

Hines in any event is not the solution nationwide. In 2003, the Seventh Circuit rejected *Hines* in *Bethea v. Robert J. Adams & Associates*.

Until Congress solves the problem by allowing chapter 7 debtors to pay their lawyers in advance, courts might protect individual bankrupts by ruling that prepaid retainers are fully earned and thus nonrefundable given the lawyers' promise to provide fixed-fee services. Judges could still police the lawyers by ensuring they gave value for the fees they received. Finding a solution could be more problematic when lawyers charge by the hour with a promise to refund unused retainers.

State legal ethics rules are also a problem because they are designed to protect clients from unscrupulous lawyers who charge up front and provide little later. States could fashion laws specifically for bankruptcy to ensure that individuals will have legal representation, but that would not solve the problem nationwide.

The opinion is *Ulrich v. Schian Walker PLC (In re Boates)*, 2016 BL 185297 (B.A.P. 9th Cir. June 9, 2016).

Creditors, rejoice! Substantial contribution is rewarded, at least in the Sixth Circuit.

Sixth Circuit Splits with Third on Substantial Contribution in Chapter 7

The Sixth Circuit disagreed with a sister appeals court by allowing creditors in chapter 7 to have an administrative claim for a "substantial contribution," even though Section 503(b)(3)(D) only lists chapters 9 and 11 as the types of cases where they are allowed.

The Sept. 21 opinion by Circuit Judge Bernice B. Donald evidently represents the minority view. According to the dissent by Circuit Judge Kathleen M. O'Malley, the Third Circuit and at least 25 lower courts have held that a creditor's substantial contribution claim can succeed only in chapters 9 and 11.

Three creditors contributed to a chapter 7 case by initiating proceedings that resulted in removing the trustee. The substitute trustee sued the former trustee and an insurance company, resulting in a settlement characterized by the bankruptcy judge as contributing in part to a "substantial benefit" to the estate and creditors. The bankruptcy judge nonetheless denied a substantial contribution claim, saying it was not authorized by subsection (b)(3)(D).

Judge Donald reversed, beginning her analysis by saying that "equitable principles govern the exercise of bankruptcy jurisdiction." She largely based her decision on use of the word "including" before the list of administrative claims enumerated in subsection (b).

Given the use of "including," Judge Donald said Congress left the door open for courts to award administrative claims for expenses not specifically mentioned in Section 503(b)'s subsections.

The plain meaning of the subsection did not require denying the claim, Judge Donald said, because the statute nowhere says that expenses of the sort cannot be allowed in chapter 7. She also said the result was not compelled by the canon of construction known as "*expressio unis est exclusion alerius*," or the "expression of one thing excludes the other."

To Judge Donald's way of thinking, denying reimbursement "would disincentivize participation in the bankruptcy process" and "impugn the fundamental notion of bankruptcy's equitable relief."

The opinion is *Mediofactoring v. McDermott* (*In re Connolly North America LLC*), 802 F.3d 810 (6th Cir. Sept. 21, 2015).

A split is brewing on chapter 13 debt limits for couples filing jointly.

Georgia Judge Retains Individual Debt Limit for Joint Chapter 13s

A split is growing among the bankruptcy courts on the debt limit for a couple filing jointly in chapter 13.

Arguably referring to joint filers, the last half of Section 109(e) limits eligibility in chapter 13 to "an individual with regular income and such individual's spouse ... that owe, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts that aggregate less than $373,175...."

According to Bankruptcy Judge James R. Sacca of Atlanta, five courts interpret the section to mean that spouses who file jointly have twice the individual unsecured debt limit. He found one judge, from Illinois, who held that the $373,175 limit also applies to a joint filing.

The case before Judge Sacca involved a couple who filed jointly, each with regular income. For each spouse separately, the individual and joint debts were less than the limit. Aggregated, however, their debts exceeded the limit.

Judge Sacca upheld the trustee's objection to confirmation of the plan, saying that Section 109(e) "expressly treats the unsecured debts of joint debtors in the aggregate." Courts holding to the contrary rely on policy arguments, not the language of the statute, according to Judge Sacca.

Judge Sacca rejected the argument that the last half of Section 109(e), quoted above, applies to cases where one spouse has regular income and the other does not.

Used in connection with the debt limit, the word "aggregate" was pivotal for Judge Sacca. It means, he said, that $373,175 is the couple's aggregate debt limit.

Judge Sacca may have an overly narrow reading of the statute because each spouse can have debt up to the limit if they file separately. The text could be interpreted to make a couple eligible for chapter 13 if their aggregate debt is less than the limit when only one spouse has regular income.

Courts should keep in mind that the statute was written when women were less likely to be working mothers.

The opinion is *In re Pete*, 541 B.R. 917 (N.D. Ga. Dec. 8, 2015).

Arbitration

Delaware's Judge Shannon protects workers' rights, disagreeing with some circuit courts.

Arbitration Agreements Held Unenforceable in WARN Act Litigation

Bankruptcy Judge Brendan L. Shannon wrote a decision on the cutting edge of issues where courts are split on the ability of workers to sue collectively for improper early termination under the National Labor Relations Act, or NLRA.

The Oct. 11 opinion also explores the so-called *Chevron* deference doctrine in a difficult case where the NLRA seemingly conflicts with the Federal Arbitration Act, or FAA.

The Arbitration Agreement

Two years before a retailer filed a chapter 11 petition in Delaware, an employee signed an agreement requiring arbitration of any employment disputes. The agreement also barred the employee from bringing class claims in arbitration.

The arbitration agreement gave the employee a 30-day window to opt out of the arbitration agreement. The employee did not opt out.

The employee was among those who were fired when the retailer terminated all operations in chapter 11, before selling the assets. On behalf of a class of workers, the employee initiated an adversary proceeding in bankruptcy court, alleging that the debtor violated the federal Worker Adjustment and Retraining Notification Act and a comparable California law requiring employers to give 60 days' notice of mass firings.

The debtor filed a motion asking Judge Shannon to compel arbitration and provide that the arbitrator could only rule on the named plaintiff's individual claim.

The motion to compel arbitration raised complex issues given the seeming conflict between two federal statutes. On one hand, there is the FAA, with its strong federal policy favoring arbitration. On the other, the NLRA arguably bars employers from requiring workers to arbitrate and waive their right to file class actions.

Issue One: ‘Concerted Activities’ Protected

For Judge Shannon, the first question was deciding whether the NLRA protects workers’ rights to file class suits. He interpreted Section 7 of the NLRA, which protects workers’ ability to “engage in other concerted activities” for their “mutual aid or protection.”

He followed courts that have held that the statutory reference to “concerted activities” gives workers the right to “collective adjudications,” or class suits. He went on to say that allowing class suits “furthers the policies underlying the NLRA.”

Consequently, Judge Shannon held that Congress has “spoken directly” in the NLRA and created a “substantive right” for employees to “proceed collectively” to vindicate their rights under Section 7.

Issue Two: *Chevron* Deference

Recently, the National Labor Relations Board, or NLRB, interpreted Section 7 to mean that workers have a substantive right to bring class or collective suits. The debtor argued that the NLRB’s interpretation was not entitled to *Chevron* deference because the FAA was beyond the labor board’s purview.

Judge Shannon disagreed, finding that *Chevron* requires the court to give the Board’s interpretation “considerable deference.” To reach his conclusion, Judge Shannon saw the NLRB as interpreting only the NLRA, not also the FAA, contrary to the holding of some courts, including the Fifth Circuit.

Even if he were wrong in having previously held that NLRA Section 7 on its face ensures workers’ rights to bring collective suits, Judge Shannon said that invocation of the *Chevron* deference doctrine requires the same result, because the NLRB’s decisions were “rational and consistent” with Section 7. He therefore declined to follow courts holding that collective suits are not protected by Section 7.

Issue Three: Substantive Rights

The debtor contended that protection of a class suit is merely procedural and thus not protected by Section 7.

Although the ability to mount a class action is usually a procedural right, Judge Shannon followed the Seventh Circuit, holding that the right to collective action is an “independent substantive right” granted by NLRA Section 7.

Issue Four: Class Waiver Unenforceable

The debtor argued that the waiver of the right to mount a class arbitration is unenforceable because the FAA mandates enforcement of arbitration agreements as written.

Again, Judge Shannon disagreed, citing Section 2 of the FAA, which provides that arbitration agreements are enforceable except "upon such grounds as exist at law or in equity."

Although the Fifth Circuit found conflict between the FAA and the NLRB, Judge Shannon followed the Seventh Circuit, finding no conflict because, he said, FAA Section 2 does not require enforcement of class waivers. He said the "FAA's savings clause prevents a conflict between the statutes."

Judge Shannon therefore concluded that the class wavier was unenforceable because Section 7 of the NLRB is a law falling within the exception contained in Section 2 of the FAA.

Issue Five: No Waiver Via 'Opt Out'

The debtor relied on a 2014 Ninth Circuit decision holding that an arbitration agreement is enforceable if the employee could have opted out. Judge Shannon said that the appeals court did not refer to any NRLB decisions nor did it discuss *Chevron* deference.

While no other circuits have directly addressed the issue, Judge Shannon concluded that the ability to opt out does not eradicate rights under NLRA Section 7. In that regard, he interpreted the Seventh Circuit's *Lewis* decision as intimating disagreement with the Fifth Circuit.

To bolster his conclusion, Judge Shannon cited a recent decision by the NLRB holding that requiring an employee to opt out of an arbitration agreement interferes with workers' rights under the NLRA.

Even though the Fifth Circuit summarily reversed the NLRB, Judge Shannon felt compelled by *Chevron* deference to follow the Board.

Judge Shannon did not reach the question of certifying a class or rule on the validity or invalidity of WARN Act claims. In a footnote, Judge Shannon said that the issues were "core." If an appellate court decides that the issues were non-core, he said that that his opinion should be taken as proposed findings and conclusions.

By concluding that the NLRA renders the arbitration agreement unenforceable, Judge Shannon was not called upon to utilize judge-made law for overriding an arbitration agreement in the bankruptcy context. In a *Lehman* case decided on Oct. 6 by the Second Circuit, the appeals court reiterated the two-part test that Judge Shannon would have been obliged to employ were it not for Section 7 of the NLRA.

The two-part test first requires that the dispute be "core." Second, the court must conclude that arbitration "would severely conflict" with a purpose of the Bankruptcy Code. Courts have tended to enforce arbitration agreements in the non-NLRA context when debtors attempt to mount class actions in bankruptcy.

To read ABI's discussion of the *Lehman* decision, click here. For an example of a non-employment case where arbitration was enforced in bankruptcy, click here.

The opinion is *Chan v. Fresh & Easy LLC (In re Fresh & Easy LLC)*, 15-51897 (Bankr. D. Del. Oct. 11, 2016).

Enforcing arbitration clause turns on core vs. non-core distinction.

Arbitration Clause Nixes Class Suit for an Automatic Stay Violation

Courts seem headed toward a rule allowing an individual bankrupt to sue for an alleged stay violation despite an arbitration clause, although an arbitration clause will be enforced if the same debtor initiates a class action.

A chapter 7 debtor filed a class action against a retailer for attempting to collect a discharged debt. She sought damages and attorneys' fees under Section 362(k) of the Bankruptcy Code.

After Bankruptcy Judge Randall L. Dunn of Portland, Ore., recommended withdrawing the reference, District Judge Michael H. Simon held a hearing, took evidence, and decided on Jan. 22 that the arbitration clause was enforceable outside of bankruptcy. He then held that the result was the same in bankruptcy because the debtor was pursuing a class action.

Attempting to defeat invocation of the Federal Arbitration Act and its policy of rigorous enforcement of arbitration clauses, the debtor argued that requiring individual enforcement of claims for stay violations would conflict "with the underlying purpose of the Bankruptcy Code" because "individual arbitration is not economically viable."

Judge Simon read the Ninth Circuit's *Schwartz-Tallard* decision in 2015 as meaning that Congress intended to permit suits by individual debtors for their own benefit. The appeals court, according to Judge Simon, perceived a difference between core and non-core proceedings. He said that courts do not have discretion to compel arbitration in core proceedings because it "would inherently conflict with the underlying purposes of the Bankruptcy Code."

Enforcing the arbitration clause and dismissing the class action, Judge Simon also found guidance from the Second's Circuit's 2006 decision in *MBNA Am. Bank v. Hill* and held that filing a class action is an admission that the claim was "not integral to her bankruptcy."

Judge Simon's opinion is similar in result to *Belton v. GE Capital Consumer Lending Inc.*, where District Judge Vincent L. Briccetti of White Plains, N.Y., enforced an arbitration clause and dismissed a class action alleging violation of a discharge injunction.

The opinion is *Campos v. Bluestem Brands Inc.*, 15-cv-629 (D. Or. Jan. 22, 2016).

Bankrupts are left to the mercy of arbitrators to enforce discharge injunctions.

Creditors Can Compel Arbitration of Discharge Violations

A former bankrupt must arbitrate a claim that a creditor violated the discharge injunction by reporting that a debt was charged off rather than erased in bankruptcy, according to a district judge in White Plains, N.Y.

It is unclear from the decision whether the result would have been different had the debtor been seeking to enforce the discharge injunction only in his or her own case and not as a class action.

Two debtors reopened their chapter 7 cases to file class action suits against creditors that had told credit reporting agencies that their debts were charged off, not discharged. The debtors contended that the erroneous reports violated their discharge injunctions under Section 524(a)(2).

When Bankruptcy Judge Robert Drain denied the creditors' motions to enforce arbitration clauses in their credit agreements, the creditors appealed and won a reversal from District Judge Vincent L. Briccetti on Oct. 14.

Judge Briccetti relied in significant part on the Second Circuit's 2006 decision in *MBNA America Bank v. Hill*, which upheld an arbitration clause when the debtors filed class actions to enforce the automatic stay.

The result turned on the Federal Arbitration Act and its "liberal federal policy favoring arbitration," Judge Briccetti said. The question for him was whether Congress intended to preclude arbitration of a statutory federal right, as shown by an "inherent conflict" between arbitration and the Bankruptcy Code.

Judge Briccetti was persuaded by Section 1334(b) of the Judiciary Code, which does not give bankruptcy courts exclusive jurisdiction over claims arising under the Bankruptcy Code. In the creditors' favor, he cited the provision in Section 1334 giving bankruptcy courts exclusive jurisdiction over awards of compensation, thus cutting against the notion that Congress did not intended to exempt discharge enforcement from arbitration.

There was no "severe conflict" between the Bankruptcy Code and the Federal Arbitration Act that would "seriously" and "necessarily" jeopardize the "goal of centralized resolution of purely bankruptcy issues," Judge Briccetti said. Citing *MBNA America Bank*, he held that it is not enough to allege "a violation of an important, even fundamental, Bankruptcy Code provision."

The debtors are moving for leave to take an interlocutory appeal to the Second Circuit.

Judge Bricetti did not cite the *Lehman* case, decided two weeks earlier, in which another Southern District judge found a "severe conflict" and upheld a decision by the bankruptcy court barring arbitration over the subordination of claims. The *Lehman* decision, by District Judge Edgardo Ramos, is discussed above.

The opinion is *Belton v. GE Capital Consumer Lending Inc. (In re Belton)*, 15-cv-1934, 2015 WL 6163083 (S.D.N.Y. Oct. 14, 2015).

ROCHELLE'S DAILY WIRE

Creditors bat 500 this fall when trying to compel arbitration in the Southern District of New York.

Subordination Clause Held Ineligible for Arbitration

With different results, arbitration clauses were the topic of two decisions handed down within two weeks of each other in Manhattan district courts.

The liquidation of Lehman Brothers Inc. teaches that an arbitration clause cannot be enforced when the issue concerns the subordination of hundreds of employees' claims.

In a case decided a fortnight later, individual debtors trying to mount class actions were unable to overcome an arbitration clause. That case, *Belton v. GE Capital Consumer Lending Inc.*, is discussed in the following item.

The case where creditors lost involved Lehman, the largest broker ever liquidated. Decades before it went bankrupt, the brokerage established a deferred compensation plan allowing senior employees to set aside some of their income in exchange for retirement benefits to be paid years or decades later. To comply with tax laws, the plan provided that the workers' claims would be subordinated to all other creditors' claims in the event of bankruptcy.

The compensation plan called for arbitration of disputes in the stock exchange. Hundreds of employees joined together and filed a motion calling on the bankruptcy judge to have an arbitrator decide whether the subordination clause was enforceable.

The bankruptcy judge made findings of fact at the conclusion of a hearing and denied the arbitration motion. Manhattan District Judge Edgardo Ramos upheld the bankruptcy judge in an opinion on Sept. 30. The employees are appealing to the Second Circuit; their brief currently is not due until Feb. 10.

Judge Ramos began with the proposition that the policy in the Federal Arbitration Act favoring arbitration must be "rigorously enforced," to use words penned by the Supreme Court. According to Second Circuit precedent, arbitration clauses will be overridden only when there is an "inherent conflict" between arbitration and another statute.

In the bankruptcy context, the Second Circuit has a two-part test, the first being an analysis of whether the dispute is core or non-core. Even if the question is core, the second part of the test provides that an arbitration clause will not be overridden unless litigation outside of bankruptcy court "would seriously jeopardize the objectives of the Bankruptcy Code," the Second Circuit proclaimed in *MBNA Bank NA v. Hill*.

Judge Ramos held that the bankruptcy court correctly decided that subordination issues are "quintessentially core bankruptcy proceedings." He also upheld the bankruptcy court's findings of a "severe conflict" between arbitration and the Code's objectives.

Given the lower court's findings, there was no abuse of discretion in refusing to compel arbitration, Judge Ramos held.

The opinion is *344 Individuals v. Giddens (In re Lehman Brothers Holdings Inc.)*, 14-civ-7643, 2015 WL 5729645 (S.D.N.Y. Sept. 30, 2015).

Municipal Debt Adjustment

ROCHELLE'S DAILY WIRE

***Dissenter implores appeals court to sit*
en banc *and reject equitable mootness.***

Sixth Circuit Split Decision Upholds Equitable Mootness in Chapter 9

Over a vigorous dissent, the Sixth Circuit dismissed an appeal from confirmation of Detroit's chapter 9 plan, relying on the judge-made doctrine of equitable mootness.

Finding dubious constitutional or statutory basis for the doctrine in either chapter 9 or 11, the dissenter urged the Sixth Circuit to rehear the case *en banc*. A similar case involving equitable mootness in municipal bankruptcy is pending in the Eleventh Circuit.

Detroit's Chapter 9 Plan

Detroit confirmed its municipal debt adjustment plan in late 2014. Although the plan reduced municipal workers' pensions by 4.5%, 73% of city employees voted for the plan because the shortfall in the pension system's funding would have required a 27% reduction in promised retirement benefits. Increased funding under the plan to enhance workers' pensions resulted from an $816 million contribution by the city, state and third parties.

Dissenting city workers appealed the confirmation order, but the district court dismissed the appeal, relying on equitable mootness. The majority opinion on Oct. 3 by Circuit Judge Alice M. Batchelder also dismissed the appeal as equitably moot.

The Majority Opinion

The majority easily and adamantly applied equitable mootness, in the process holding that the doctrine is properly extended from chapter 11 to chapter 9. Judge Batchelder said the city had issued $1 billion in debt and consummated countless other "colossal" and irrevocable transactions on the faith of the confirmation order, which had not been stayed pending appeal.

The majority said the case was "not a close call," in part because the panel was bound by a prior Sixth Circuit opinion that sanctioned equitable mootness in chapter 11 cases.

Judge Batchelder disagreed with *Bennett v. Jefferson County*, where an Alabama district court held that equitable mootness does not apply in chapter 9 cases. Quoting the Detroit lower court's decision, she said that "equitable mootness likely applies 'with greater force to the city's chapter 9 plan, which affects thousands of creditors and residents.'"

The Dissent

Dissenting, Circuit Judge Karen Nelson Moore conceded that every circuit to visit the issue has invoked equitable mootness but said "its legal foundations are shaky, at best." Attacking the doctrine head-on, she cited Justice Samuel Alito, who, as an appeals court judge, dissented from the *en banc* Third Circuit's 1996 opinion in *Continental Airlines* embracing equitable mootness.

She criticized other circuits for adopting the doctrine with "minimal exploration of its legal basis." In the statutes, she found no textual support, while saying that "statutory provisions regarding bankruptcy appeals arguably preclude the doctrine." She said it "contradicts the relevant appellate-jurisdiction statutes and purports to authorize making of federal common law despite the complete lack of evidence that Congress intended to delegate such authority to the courts."

Judge Batchelder said that equitable mootness "raises separation of powers concerns" because it renders decisions by Article I bankruptcy courts immune from review by Article III judges. She said that review in an Article III court is the "key" to Supreme Court decisions limiting the powers of bankruptcy courts.

Observing that equitable mootness creates "a new pseudo-jurisdictional rule that appears to be boundless," Judge Batchelder said it is "high time" for the Sixth Circuit to review the doctrine *en banc*.

Jefferson County is pending in the Eleventh Circuit on a certified interlocutory appeal. The case has been fully brief since January, but the appeals court has yet to schedule oral argument.

Judge Moore was a *magna cum laude* graduate from Harvard Law School and a clerk for Supreme Court Justice Harry Blackmun. While teaching at Case Western Reserve Univ. Law School, she was appointed to the circuit court in 1995. Judge Batchelder was a bankruptcy judge before she was appointed to the district court and then to the circuit court in 1991.

The opinion is *Ochadleus v. City of Detroit (In re City of Detroit)*, 15-2194 (6th Cir. Oct. 3, 2016).

ROCHELLE'S DAILY WIRE

The score is 2-1 in favor of equitable mootness in chapter 9 plan confirmation.

Franklin Funds Lost Again Challenging Stockton's Municipal Debt Plan

The Ninth Circuit Bankruptcy Appellate Panel sided with District Judge Bernard A. Friedman from Detroit by holding that the doctrine of equitable mootness applies to appeals from confirmation of chapter 9 municipal debt-adjustment plans, not only to corporate reorganizations in chapter 11.

In an appeal from the confirmation of Jefferson County, Ala.'s chapter 9 plan, District Judge Sharon Lovelace Blackburn of Birmingham held that equitable mootness was unavailable.

The appellate panel decision came down on Dec. 11 in the municipal bankruptcy of Stockton, Calif., which filed for chapter 9 protection in June 2012. Bankruptcy Judge Christopher M. Klein confirmed the plan in February, overruling objections from Franklin Resources Inc. high-yield bond funds. All other major bondholder, employee and creditor groups settled and accepted their treatment in Stockton's plan.

For the three-judge appellate panel, Bankruptcy Judge Randall L. Dunn of Portland, Ore., noted that his court in 2013 invoked equitable mootness in Vallejo, Calif.'s chapter 9 case. Equitable mootness is a judge-made rule of law that bars an appeal from a confirmation order in cases where overturning the bankruptcy court would pull the props out from under a consummated plan.

Judge Dunn was persuaded by the reasoning in the Detroit opinion, saying that equitable mootness has a "legitimate role to play" in chapter 9 just as it does in chapter 11. He also said Stockton's plan did not have potential constitutional defects like Jefferson County's. In the Alabama case, the district judge held that the objectors were entitled to have an Article III adjudication of their constitutional claims.

Invoking equitable mootness, Judge Dunn dismissed Franklin's appeal from confirmation as a whole because it would have a "potentially devastating impact on creditor constituencies" not participating in the appeal.

Franklin argued that confirmation was not entirely moot because an appellate court could simply require a larger payment on its claim. Judge Dunn recognized Ninth Circuit authority, which holds that it is not generally impossible to fashion a remedy seeking "only money."

Consequently, Judge Dunn addressed and rejected Franklin's objections to the merits of the plan.

Franklin wanted Judge Klein to nix the plan unless the city cut workers' pensions, but Judge Klein said that Franklin was wrong in contending that the capital market creditors were recovering 1 percent on their claims while workers were unaffected by the bankruptcy.

Judge Klein pointed out how workers took pay cuts and lost benefits, stating that the "value of what employees and retirees lose under the plan is greater than what capital markets creditors lose."

Judge Klein calculated worker losses at $550 million, more than 10 times Franklin's loss. He said the employees were recovering 1 percent on their claims, the same as Franklin on the $32 million unsecured portion of its $36 million in bonds.

Based on Judge Klein's findings of fact, Judge Dunn rejected Franklin's argument that the plan unfairly discriminated and improperly classified its claims. He therefore dismissed the appeal generally as equitably moot while upholding the bankruptcy court's treatment of Franklin's unsecured claim.

The opinion is *Franklin High Yield Tax Free Income Fund v. City of Stockton, California (In re City of Stockton, California)*, 542 B.R. 261 (B.A.P. 9th Cir. Dec. 11, 2015).

Detroit and Birmingham judges disagree on equitable mootness for municipalities.

Equitable Mootness Held Applicable to Chapter 9 Debt Adjustments

District courts in the Sixth and Eleventh Circuits disagree on applying equitable mootness to appeals from confirmation of chapter 9 municipal debt adjustment plans.

In September 2014, District Judge Sharon Lovelace Blackburn from Birmingham, Ala., ruled against Jefferson County and held that equitable mootness does not apply in chapter 9 cases. District Judge Bernard A. Friedman from Detroit wrote an opinion one year later in which he disagreed with Judge Blackburn, saying her distinctions between chapters 9 and 11 were "particularly problematic."

Judge Friedman was entertaining a motion by Detroit to dismiss appeals taken by dozens of pension recipients from confirmation of the city's chapter 9 plan. Detroit's is the largest municipal bankruptcy to date, with Jefferson County's in second place.

Equitable mootness is a judge-made doctrine calling for dismissal of an appeal from confirmation when modifying the plan would unravel a complex restructuring. The Third and Ninth Circuits in particular have been limiting instances in which the doctrine can be applied. The Third Circuit now applies the doctrine in only the largest reorganizations.

Judge Friedman said that the interests of 100,000 creditors and 700,000 Detroit residents "cannot be marginalized and dismissed in the broad brush manner adopted by the Jefferson County court." He believed that their "interests surely apply with greater force to the city's chapter 9 plan, which affects thousands of creditors and residents."

Judge Friedman invoked equitable mootness to dismiss the pensioners' appeal because reinstating their full claims would require a wholesale annihilation of the plan.

Judge Blackburn had denied dismissal of the Jefferson County appeal on a second theory. She held that as a life-tenured federal judge, she must hear the appeal because sewer customers contended the plan unconstitutionally locked in future rate increases to pay new bonds without enabling legislation or a vote by citizens.

Judge Blackburn held that a successful appeal by ratepayers would permit her to void "allegedly unconstitutional terms of the confirmation order" such as the "bankruptcy court's authority to set rates for sewer service." She nonetheless concluded that "some parts of the confirmation order may be impossible to reverse," such as the validity of newly issued bonds.

The Detroit opinion is *Ochadleus v. City of Detroit (In re City of Detroit)*, 14-cv-14872, 2015 WL 5697702 (E.D. Mich. Sept. 29, 2015).