

Splits and Confounding Issues Destined for the Supreme Court

Fifth and Tenth Circuit Family Feud

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##### Supreme Court

### Decisions This Term

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

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

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

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

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

The Fee Structure’s History

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

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

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

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

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

Procedural History

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

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

The debtor mounted an objection to the increase on constitutional grounds and won. Bankruptcy Judge Kevin R. Huennekens of Richmond, Va., held that the increased fees violated the Uniformity Clause, if the fee is seen as a tax, and violated the Bankruptcy Clause, if the fee is considered a user fee. In re Circuit City Stores Inc., 606 B.R. 260 (Bankr. E.D. Va. July 15, 2019). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/increased-us-trustee-fees-stick-to-%E2%80%98revolvers%E2%80%99-but-not-to-pending-cases).

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

The Fourth Circuit agreed to hear an interlocutory appeal and reversed in a 2/1 decision. The majority on the Richmond, Va.-based appeals court did not believe that the increase was arbitrary. The dissenter would have held the increase to be unconstitutional. *In re Circuit City Stores, Inc.*, 996 F.3d 156 (4th Cir. April 29, 2021). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/another-circuit-upholds-the-2018-increase-in-us-trustee-fees).

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

Applicability of the Bankruptcy Clause

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

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

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

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

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

Precedent Foretells the Outcome

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

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

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

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

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

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

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

Impermissible Lack of Uniformity

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

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

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

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

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

Final Comments by Justice Sotomayor

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

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

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

Is the Dual System Constitutionally Sound?

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

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

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

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

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

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

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

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

The debtor-plaintiff appealed and is asking the Federal Circuit to reinstate the class action. Oral argument in the Federal Circuit was postponed pending the outcome in *Circuit City*. For ABI’s report on Acadiana, [click here](https://www.abi.org/newsroom/daily-wire/court-of-claims-upholds-fee-increase-for-us-trustee-system).

[The opinion is](https://abi-opinions.s3.amazonaws.com/Siegel+v.+Fitzgerald+Sup+Ct.pdf) *Siegel v. Fitzgerald*, 21-441 (Sup. Ct. June 6, 2022).

#### Cutting back on knee-jerk invocation of arbitration, the Supreme Court says that agreements to arbitrate are no more enforceable than ordinary contracts.

# Supreme Court on Arbitration (Again): Perhaps Bankruptcy Is Exempt from Arbitration?

For the bankruptcy community, arbitration cases in the Supreme Court are important because the justices have never granted *certiorari* to decide whether arbitration agreements are generally enforceable in bankruptcy.

For example, would the high court require a debtor to arbitrate the allowance of a claim or the rejection of a contract or the question of whether a plan impairs a creditor’s claim?

This term, the Supreme Court has ruled on two arbitration cases. Both times, the Court has taken a less expansive approach, finding no special rules impelling federal courts to enforce arbitration agreements.

On March 31, Justice Elena Kagan wrote for the 8/1 majority that there must be an independent basis of federal jurisdiction to mount an action in federal court to confirm (or to attack confirmation of) an arbitration award. *See* *Badgerow v. Walters*, 20-1143, 142 S. Ct. 1310, 212 L. Ed. 2d 355 (Sup. Ct. March 31, 2022). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-rules-again-on-arbitration-saying-nothing-explicitly-about).

Writing for the unanimous Court on May 22, Justice Kagan overruled the majority of circuits, which had held that a “party can waive its arbitration right by litigating only when its conduct has prejudiced the other side.”

Aligning the Supreme Court with the *minority* of circuits, Justice Kagan held that “the [Federal Arbitration Act’s] ‘policy favoring arbitration’ does not authorize federal courts to invent special, arbitration-preferring procedural rules.”

The Employer’s Waiver of Arbitration

An hourly worker had signed an arbitration agreement when she accepted employment. She later brought a purported class action against the employer in district court in Iowa, alleging violations of the Fair Labor Standards Act.

The employer filed and lost a motion to dismiss. Answering the complaint, the employer raised 14 affirmative defenses, but not arbitration. Eight months into the lawsuit, the employer filed a motion to stay the litigation and compel arbitration.

The Eighth Circuit had previously held that a party could waive arbitration only if there were prejudice to the other party. The district court ruled that the prejudice requirement had been satisfied, but the Eighth Circuit reversed in a 2/1 opinion. The dissenter in the appeals court “raised doubts” about the prejudice requirement, Justice Kagan said.

The Supreme Court granted *certiorari* to resolve a circuit split. According to Justice Kagan, nine circuits “have invoked ‘the strong federal policy favoring arbitration’ in support of an arbitration-specific waiver rule demanding a showing of prejudice.” The Seventh and the District of Columbia Circuits “have rejected that rule,” Justice Kagan said.

Ruling Based on Principles of Contract Law

Without deciding, Justice Kagan assumed that federal courts properly invoke federal law on waiver in arbitration cases. She tackled the question of whether courts “may create arbitration-specific variants of federal procedural rules, like those concerning waiver, based on the FAA’s ‘policy favoring arbitration.’”

“Outside the arbitration context,” Judge Kagan said, “a federal court assessing waiver does not generally ask about prejudice.” Instead, she said, “the court focuses on the actions of the person who held the right; the court seldom considers the effects of those actions on the opposing party.”

The Eighth Circuit had applied a “rule found nowhere else,” Judge Kagan said.

Justice Kagan’s opinion has the effect of putting limits on the policy favoring arbitration. She said that the “policy is to make ‘arbitration agreements as enforceable as other contracts, but not more so.’ *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404, n. 12 (1967).”

Justice Kagan held that “a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation.” She explained that the policy “*is about treating arbitration contracts like all others, not about fostering arbitration*.” [Emphasis added.]

Justice Kagan vacated the judgment of the Eighth Circuit and remanded for the lower court to “focus” on the employer’s conduct. “Our sole holding today is that it may not make up a new procedural rule based on the FAA’s ‘policy favoring arbitration,’” she said.

Observations

The two arbitration opinions this term by Justice Kagan are the latest installments in the Supreme Court’s recent push to limit or cut back on the adoption of federal common law.

In Rodriguez v. F.D.I.C., 140 S. Ct. 713, 206 L. Ed. 2d 62 (Feb. 25, 2020), Justice Neil M. Gorsuch used a bankruptcy case to rule that federal courts may not employ federal common law to decide who owns a tax refund when a parent holding company files a tax return but a subsidiary generated the losses giving rise to the refund. To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-uses-a-bankruptcy-case-to-limit-the-use-of-federal-common-law).

To this writer’s way of thinking, it is questionable whether there is any longer a federal policy favoring arbitration. Justice Kagan’s opinion makes enforcement of an arbitration agreement nothing more than a question of contract interpretation.

Let us assume that a creditor has an otherwise enforceable arbitration agreement in a contract with a debtor in bankruptcy.

It goes without saying that the contract bends to the plethora of rights conferred by the Bankruptcy Code on debtors and trustees. That is to say, contracts are enforceable only to the extent permitted by the Bankruptcy Code, and the Code presumes that virtually all disputes are relegated to the district or bankruptcy courts, absent remand or modification of the automatic stay.

But here’s the rub: The Supreme Court has long held that courts must compel arbitration unless a federal statute manifests a clear intention to override the FAA. Does the Bankruptcy Code manifest a clear intention to override an arbitration agreement?

Is “clear intention” still the standard, or has it been modified by focusing on contract interpretation?

[The opinion is](https://abi-opinions.s3.amazonaws.com/Morgan+v+Sundance.pdf) *Morgan v. Sundance Inc.*, 21-328 (Sup. Ct. May 23, 2022).

#### The Supreme Court is still giving no hints about whether arbitration agreements are enforceable in bankruptcy cases.

# Supreme Court Rules Again on Arbitration, Saying Nothing Explicitly About Bankruptcy

We follow arbitration cases in the Supreme Court because the justices have never granted *certiorari* to decide whether arbitration agreements are generally enforceable in bankruptcy. For example, must a debtor arbitrate the allowance of a claim or rejection of an executory contract or even enforcement of a plan that impairs a creditor’s claim?

Late last week, the justices ruled 8/1 in *Badgerow v. Walters*, 20-1143 (Sup. Ct. March 31, 2022), that there must be an independent basis of federal jurisdiction to mount an action in federal court to confirm (or to attack confirmation of) an arbitration award. The opinion means this: The federal court may have had subject matter jurisdiction to compel arbitration but may not have jurisdiction later to confirm or enforce the resulting award.

As expected, the opinion has no language that would apply expressly to bankruptcy. At best, the new opinion could be read to mean that federal courts do not champion arbitration in all circumstances.

Another arbitration case was argued in the Supreme Court on March 30: *Viking River Cruises Inc. v. Moriana*, 20-1573 (Sup. Ct.). The case deals with the ability of a state to curtail an arbitration agreement. We will not speculate on the outcome.

The Issue in *Badgerow*

An employee had an arbitration clause in her employment agreement. She launched an arbitration against her employer and lost.

Alleging that the arbitration proceedings has been infected with fraud, she sued her employer in state court to vacate the arbitration award. The employer removed the suit to federal district court. The district court decided that it had jurisdiction, denied the employee’s motion to remand, and confirmed the award.

The Fifth Circuit affirmed. Like the district court, the New Orleans-based appeals court looked through the petition and found subject matter jurisdiction because the employee’s underlying claims were based on federal law.

The Supreme Court granted *certiorari* to resolve a 4/2 circuit split, where the majority of circuits found jurisdiction if the underlying dispute was based on federal law.

Different Jurisdiction for Compelling and Confirming

Justice Elena Kagan reversed, writing the opinion for the majority. She based the outcome on differing provisions in the Federal Arbitration Act, or FAA.

Section 4 of the FAA deals with enforcing arbitration agreements. It provides that a party may petition to enforce an arbitration agreement in “any United States district court which, save for such agreement, would have jurisdiction . . . of the subject matter of a suit arising out of the controversy between the parties.”

In *Vaden v.* *Discover Bank*, 556 U.S. 49 (2009), Justice Kagan said, the Supreme Court held that the court will “look through” to the underlying dispute to decide whether there is jurisdiction. If there is diversity or if a federal question will be arbitrated, then the district court has jurisdiction to compel arbitration.

Enforcement of an arbitration award does not fall under Section 4 of the FAA. Rather, enforcement is under Sections 9 and 10. Justice Kagan based her holding on the conclusion that “[t]hose sections lack Section 4’s distinctive language directing a look-through, on which *Vaden* rested.”

In other words, ordinary rules about subject matter jurisdiction apply to petitions for confirmation of an arbitration award because Sections 9 and 10 do not have their own special provisions governing jurisdiction. When the petition to the district court is for enforcement of an award, Justice Kagan said that the court must decide whether there is jurisdiction without relying on the subject matter of the underlying dispute.

In other words, if the parties are diverse, there is jurisdiction. Or, if enforcement itself raises a federal question, there would be jurisdiction to confirm an award.

In the case on *certiorari*, Justice Kagan said that the parties were not diverse and there was no federal question regarding confirmation of the award.

Rather, the issue regarding enforcement of the arbitration award was nothing “more than a contractual resolution of the parties’ dispute . . . . And quarrels about legal settlements — even settlements of federal claim — typically involve only state law, like disagreements about other contracts.”

There being no diversity and no federal question controlling confirmation of the award, Judge Kagan reversed and remanded, since enforcement would turn on state contract law. Presumably, confirmation of the award will be vacated for lack of subject matter jurisdiction, and the employee will have her day in state court to attack the confirmation award.

Any Applicability to Bankruptcy?

On the surface, there is little or nothing on the face of the opinion regarding enforcement of arbitration agreements in bankruptcy. Furthermore, the decision deals with enforcement of arbitration awards, not enforcement of arbitration clauses.

In recent terms, the Supreme Court has been adamant about enforcing arbitration agreements. *See, e.g.*, *Epic Systems Corp. v. Lewis*, 200 L. Ed. 2d 889 (Sup. Ct. May 21, 2018). One might perhaps read *Badgerow* to mean that federal courts are not bound by the FAA to enforce arbitration clauses and awards in all circumstances. However, *Badgerow* is not based on policy. It’s based strictly on statutory interpretation.

When it comes to enforcement of arbitration agreements, *Vaden* and *Badgerow* both suggest that the bankruptcy court has “related to” jurisdiction even if there is no diversity and no federal question.

Still, having jurisdiction does not automatically mean that the bankruptcy court must enforce an arbitration clause. In *Epic*, the Supreme Court said that courts must compel arbitration unless the federal statute manifests a clear intention to override the FAA. Does the Bankruptcy Code manifest a clear intention to override an arbitration agreement?

Although it was decided before *Epiq*, some circuits still interpret Shearson/American Express Inc. v. McMahon, 482 U.S. 220 (1987), liberally by overriding arbitration agreements in bankruptcy cases, even though the Bankruptcy Code contains no express language barring enforcement of the FAA. *See, e.g.*, *Credit One Bank NA v. Anderson (In re Anderson)*, 884 F.3d 382 (2d Cir. March 7, 2018), *cert. denied*, 139 S. Ct. 144 (2018). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/second-circuit-nixes-nationwide-class-actions-for-discharge-violations).

Centrality of administration is evident throughout the Bankruptcy Code, in provisions like the automatic stay, the requirement to file claims, and the encompassing nature of “core” jurisdiction. Perhaps those (less than explicit) provisions in bankruptcy law would persuade the Supreme Court to override arbitration agreements in most bankruptcy disputes.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Badgerow.pdf) *Badgerow v. Walters*, 20-1143 (Sup. Ct. March 31, 2022)

### ‘Cert’ Granted for Next Term

#### The circuits are split on whether an innocent debtor’s liability is automatically nondischargeable when an agent or partner committed fraud.

# *Cert* Granted to Decide: Is a Principal’s Liability for an Agent’s Fraud Nondischargeable?

The Supreme Court granted *certiorari* this week to resolve a split of circuits and decide whether a debtor is saddled with a nondischargeable debt for a false representation or actual fraud under Section 523(a)(2)(A) based entirely on the fraud of a partner or agent. In other words, does the imputation of liability for fraud also result automatically in nondischargeability, or must the debtor have some degree of scienter?

The decision in *Bartenwerfer v. Buckley*, 21-908 (Sup. Ct.), likely to be argued this fall, will say whether the debtor must have known or should have known about the agent’s fraud before the debt is considered nondischargeable.

The circuits are split as follows: (1) The Second, Fourth, Seventh and Eighth Circuits hold that the debtor must have some degree of scienter before an imputed liability for fraud becomes nondischargeable, while (2) the Fifth, Sixth, Ninth and Eleventh Circuits hold that a debt is nondischargeable as to an entirely innocent debtor based on the fraud of a partner or agent.

The ‘Innocent’ Wife

A couple owned a home. They moved out to renovate and then sell the home. The husband oversaw the renovations. The wife had little to do with the renovations. After renovation, they sold the home.

The buyers sued in state court, alleging fraud in the disclosure statement for failure to disclose known defects in the home. A jury found the couple liable, resulting in a judgment against them for about $540,000, plus interest.

The couple filed a chapter 7 petition, and the bankruptcy court ruled that the debt was nondischargeable as to the husband.

Bankruptcy Judge Hannah L. Blumenstiel discharged the debt as to the wife, finding that she neither knew nor should have known that the disclosures were fraudulent. *See Buckley v. Bartenwerfer (In re Bartenwerfer)*, 596 B.R. 675 (Bankr. N.D. Cal. 2019). The Ninth Circuit Bankruptcy Appellate Panel affirmed in a nonprecedential opinion. *See Bartenwerfer v. Buckley (In re Bartenwerfer)*, 16-1277, 2017 BL 461730, 2017 Bankr. Lexis 4396, 2017 WL 6553392 (B.A.P. 9th Cir. Dec. 22, 2017).

The Ninth Circuit reversed in a nonprecedential opinion and directed the bankruptcy judge to enter judgment in favor of the creditor, declaring the debt to be nondischargeable. Raising the circuit split, the debtor-wife filed a petition for *certiorari* in December. The Supreme Court granted the petition on May 2.

The Supreme Court’s order granting review did not describe the issue on appeal. The debtor’s petition stated the question presented as follows:

May an individual be subject to liability for the fraud of another that is barred from discharge in bankruptcy under 11 U.S.C. § 523(a)(2)(A), by imputation, without any act, omission, intent or knowledge of her own?

The (Outdated?) Supreme Court Precedent

The root of the circuit split is found in what the debtor calls a misinterpretation of an 1885 decision by the Supreme Court under the Bankruptcy Act of 1867, *Strang v. Bradner*, 114 U.S. 555 (1885). There, the Court was primarily concerned with whether a partner in a law firm was entitled to a discharge. The Court said the debt was not discharged, because the partner had himself committed fraud.

According to the debtor, the Court in 1885 “simply assumed — without authority or analysis — that the liability [of other partners] was nondischargeable.”

The debtor went on to say,

[T]he Court did not actually consider the particular issue, perhaps because it was not raised on appeal, the parties having elected to focus their arguments on the underlying liability for fraud, which occupies most of the opinion.

In other words, the debtor is arguing that the Court’s pronouncement in 1885 about *per se* nondischargeability of one partner for another’s fraud is *dicta*.

The Circuits’ Opposing Camps

The circuits these days that find no *per se* liability are led by the Eighth Circuit in *Walker v. Citizens State Bank (In re Walker)*, 726 F.2d 452 (8th Cir. 1984). The St. Louis-based appeals court held that actual participation in the fraud is not required for the debt to be nondischargeable. However, the circuit said that the debt is nondischargeable if “the principal either knew or should have known of the agent’s fraud.” *Id*. at 454.

On the other side of the fence, *Deodati v. M.M. Winkler & Assocs. (In re M.M. Winkler & Assocs.)*, 239 F.3d. 746 (5th Cir. 2001), is the leading authority for a principal’s strict liability. Writing for the Fifth Circuit, Circuit Judge Edith H. Jones held “that § 523(a)(2)(A) prevents an innocent debtor from discharging liability for the fraud of his partners, regardless of whether he receives a monetary benefit.” *Id*. at 751.

Conclusion

Absent lengthy extensions, the briefs should be filed by summer, allowing for argument in the fall. As the debtor said in her *certiorari* petition, did the Ninth Circuit commit error when it “impose[d] nondischargeability upon an innocent debtor for the fraud of another without any act, omission, intent or knowledge of the debtor’s own”?

It’s a classic question that asks whether scienter is an implicit requirement before a debt is excepted from discharge under Section 523(a)(2)(A).

The face of the statute itself may or may not answer the question. The subsection renders a debt nondischargeable if it was obtained by “false pretenses, a false representation, or actual fraud.”

The subsection does not say whether the debtor must have made the false representation or committed the fraud. Still, the statute could be read to mean that any liability for fraud or misrepresentation is nondischargeable, regardless of who committed the fraud.

The drafters of the Code did not explicitly overrule *Strang*, of which they surely were aware. Being vague on the issue now in the Supreme Court, did they mean for the courts to decide whether the debtor must be guilty of fraud?

We will have the answer about one year from now.

[The case is](https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/21-908.html) *Bartenwerfer v. Buckley*, 21-908 (Sup. Ct.).

### ‘Cert’ Denied

#### The Supreme Court on June 13 declined to hear two bankruptcy cases in the term to begin next October.

# Supreme Court Won’t Rule on Remedies for Overpayments and Violation of Rule 3002.1

In the term to begin this coming October, the Supreme Court will not be hearing cases raising two bankruptcy questions.

The Court will not decide (1) whether a refund is the proper remedy for a chapter 11 debtor who paid higher U.S. Trustee fees that were held unconstitutional by the Court on June 6, and (2) whether bankruptcy courts may impose contempt sanctions for violations of Bankruptcy Rule 3002.1, the rule that requires lenders to give notice within 180 days of fees or expenses being charged to a chapter 13 debtor.

*John Q. Hammons Fall*

Reversing the majority opinion from the Fourth Circuit, the Supreme Court ruled unanimously on June 6 that the increase in fees payable to the U.S. Trustee system in 2018 violated the uniformity aspect of the Bankruptcy Clause of the U.S. Constitution because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees. *Siegel v. Fitzgerald*, 21-441, 2022 BL 194063, 2022 US Lexis 2681 (Sup. Ct. June 6, 2022). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/2018-increase-in-us-trustee-fees-held-unconstitutional-by-the-supreme-court).

Although remedy had been a focus of questions from the justices during oral argument in *Siegel*, the Court pointedly remanded for the lower court to determine the proper remedy, because the Fourth Circuit had not been required to rule on remedy. The government has been contending in the lower courts and in the Supreme Court that chapter 11 debtors are not entitled to a refund of overpayments.

The *certiorari* petition in *Office of the U.S. Trustee v.* *John Q. Hammons Fall 2006 LLC*, 21-1078 (Sup. Ct.), raised the remedy question that the Supreme Court ducked in *Siegel*.

The Tenth Circuit had ruled in *John Q. Hammons Fall* that the U.S. Trustee fee increase was unconstitutional and that a refund was the proper remedy. *John Q. Hammons Fall 2006 LLC v. U.S. Trustee (In re John Q. Hammons Fall 2006 LLC)*, 15 F.4th 1011 (10th Cir. Oct. 5, 2021). To read ABI’s report on the circuit’s decision in *John Q.* *Hammons Fall*, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-likely-to-tackle-2018-us-trustee-fee-increase).

In *John Q. Hammons Fall*, the Supreme Court could have denied *certiorari*, in which event the remedy of refund would have been binding precedent in the Tenth Circuit and influential elsewhere.

Instead, the Supreme Court granted *certiorari* in an order on June 13, vacated the judgment and “remanded to the United States Court of Appeals for the Tenth Circuit for further consideration in light of *Siegel v. Fitzgerald*, 596 U.S. \_\_\_ (2022).” For the Supreme Court’s docket in *John Q. Hammons Fall*, [click here](https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/21-1078.html).

The Tenth Circuit will surely cite *Siegel* and affirm its ruling that the fee increase was unconstitutional. It is not certain, however, that the Tenth Circuit will reflexively uphold its prior decision on remand. To read the tea leaves, the judges on the Tenth Circuit will likely read the transcript of oral argument in *Siegel*, in hopes of divining how the Supreme Court might rule on remedy.

Even if the Tenth Circuit again upholds refund as the remedy, it’s unlikely that the Supreme Court will grant *certiorari* immediately to rule on remedy, in this writer’s view. The issue of remedy is not well developed among the circuits, and a class action now pending in the Federal Circuit raises the issue starkly.

The Federal Court of Claims dismissed a class action, believing (incorrectly, as it turns out) that the disparate fees did not violate the Bankruptcy Clause. Acadiana Management Group LLC v. U.S., 19-496, 151 Fed. Cl. 121 (Ct. Cl. Nov. 30, 2020). The debtor-plaintiff appealed and is asking the Federal Circuit to reinstate the complaint. Oral argument in the Federal Circuit was postponed pending the outcome in Siegel. Acadiana Management Group LLC v. U.S., 21-1941 (Fed. Cir.). For ABI’s report on Acadiana, [click here](https://www.abi.org/newsroom/daily-wire/court-of-claims-upholds-fee-increase-for-us-trustee-system).

The complaint in *Acadiana* will be reinstated, based on *Siegel*. Liability seems to be established by *Siegel*, but whether the Court of Claims certifies a class is another question. If a class is certified, the question of remedy will remain for the Court of Claims and the Federal Circuit to decide.

Rule 3002.1

Last year, the Second Circuit held in *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), that bankruptcy courts may not impose contempt sanctions for violating Bankruptcy Rule 3002.1. Rather, the majority ruled over a vigorous dissent that a debtor may only recover compensatory damages, which often will be nominal. To read ABI’s report on *Gravel*, [click here](about:blank).

One month later, a bankruptcy judge in Texas disagreed with the Second Circuit’s majority and held that a debtor can mount a claim for sanctions and punitive damages under Bankruptcy Rule 3002.1(i)(2) when a lender violates Rule 3002.1(b) and (c) by failing to give notice of changes in the payment, charges, fees and expenses claimed by a secured lender. *Blanco v. Bayview Loan Servicing LLC (In re Blanco)*, 633 B.R. 714 (Bankr. S.D. Tex. Sept. 14, 2021). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/texas-judge-disagrees-with-second-circuit-on-sanctions-for-violating-rule-30021).

The debtor filed a petition for *certiorari* in *Gravel*. *Sensenich v. PHH Mortgage Corp.,* 21-1322 (Sup. Ct.). A group of law professors and retired bankruptcy judges, along with the National Association of Chapter 13 Trustees, filed *amicus* briefs urging the Court to grant *certiorari* and reverse the Second Circuit.

In an unsigned order on June 13, the Supreme Court denied the *Sensenich* *certiorari* petition. Supreme Court review may not occur until there is a circuit split on the precise issue under Rule 3002.1. Otherwise, the Supreme Court would be wading into the murky area regarding a bankrupt court’s inherent power and jurisdiction to impose punitive sanctions.

For the Supreme Court’s docket in *Sensenich*, [click here](https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/21-1322.html).

The *certiorari* petitions were [*Office of the U.S. Trustee v.* *John Q. Hammons Fall 2006 LLC*](https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/21-1078.html), 21-1078 (Sup. Ct.); and [*Sensenich v. PHH Mortgage Corp.*](https://www.supremecourt.gov/search.aspx?filename=/docket/docketfiles/html/public/21-1322.html)*,* 21-1322 (Sup. Ct.).

##### Reorganization

### Fraudulent Transfers

#### Reversing in favor of the Madoff trustee, the Second Circuit rules that inquiry notice, not willful blindness, governs the good faith defense by recipients of fraudulent transfers.

# Second Circuit Revives $3.75 Billion in *Madoff* Lawsuits Against Financial Institutions

In a major victory for the trustee and victims of the Bernard Madoff Ponzi scheme, the Second Circuit again reversed District Judge Jed Rakoff, this time by holding that so-called inquiry notice is sufficient to show a lack of good faith by a transferee of a fraudulent transfer avoided under the Securities Investor Protection Act. Judge Rakoff had required the Madoff trustee to meet the higher standard of “willful blindness.”

The appeals court reversed Judge Rakoff on a second issue: Good faith is an affirmative defense to be pleaded by the defendant. In the complaint, the trustee is not required to plead facts showing the transferee’s lack of good faith.

Together, the rulings revive about 90 lawsuits against global financial institutions, hedge funds and other participants in the global financial markets. The decision allows Irving Picard, the Madoff trustee, to pursue the recovery of an additional $3.75 billion in stolen customer property, the trustee said in a statement.

The resurrected lawsuits will bring defrauded customers “as close as possible to recovering 100% of their losses,” the trustee said. A full recovery would be remarkable given that customers’ cash losses aggregate almost $19.5 billion.

The Madoff liquidation is being conducted in bankruptcy court under SIPA, which incorporates large swaths of the Bankruptcy Code, including Sections 548 and 550. The trustee filed hundreds of fraudulent transfer suits in the two years following the commencement of the liquidation in 2008.

The ‘Bad Faith’ Defendants

Most of the suits by the Madoff trustee were lodged against so-called “net winners,” meaning Madoff customers who took out fictitious profits. In reality, they were not receiving profits from investments. Rather, Madoff gave them money stolen from other investors because he never bought any securities with customers’ deposits.

The Madoff trustee benefited from the so-called Ponzi scheme presumption, where a transfer in a Ponzi scheme is presumed to be made with actual intent to defraud creditors under Section 548(a)(1)(A). The presumption is based on Bernie Madoff’s fraudulent intent, not the intent of the recipients of the fraudulent transfers.

Earlier in the Madoff liquidation, the Second Circuit held that net winners did not give value for receipt of fictitious profits and are therefore liable to pay back however much cash they took out within two years of bankruptcy in excess of the cash they invested. Because the return of a customer’s principal investments constitutes “value,” customers who took out less than they invested (so-called “net losers”) were not liable for receipt of fraudulent transfers.

In test cases decided by the Second Circuit on August 30, the Madoff trustee had reason to believe that the defendants either knew there was fraud or ignored enough red flags to be on inquiry notice. For lack of good faith, the Madoff trustee contended in his suits that the defendants were liable even for principal they took out.

The Decisions Below

There were three defendants-appellees in the Second Circuit. One was an initial transferee from Madoff who was being sued for $213 million. The other two were subsequent transferees being sued for $343 million and $6.6 million, respectively.

Early in the litigation, District Judge Rakoff withdrew the reference, reasoning that the suits involved securities law, of which SIPA arguably is part. In a decision in 2014, Judge Rakoff established two principles. *SIPC v. BLMIS (In re Madoff Sec.)*, 516 B.R. 18 (S.D.N.Y. 2014).

First, District Judge Rakoff reasoned that a SIPA trustee must plead lack of good faith in the complaint with particularity. Otherwise, he said, placing the burden on the defendant would undercut SIPA’s goal of encouraging investor confidence.

Second, District Judge Rakoff required the trustee to plead the higher standard of “willful blindness” in proving lack of good faith because a securities investor has no inherent duty to inquire about his stockbroker.

Remanded to bankruptcy court, the bankruptcy judge dismissed the complaints under the pleading standards laid down by District Judge Rakoff. The bankruptcy court did not permit the trustee to amend the complaints, saying that the trustee could not plausibly show willful blindness.

The Second Circuit accepted a direct appeal.

Good Faith in the Statutes

Good faith appears in two sections of the Bankruptcy Code pertinent to the appeal.

Under Section 548(c), an initial transferee who “takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee . . . gave value to the debtor in exchange for such transfer.” In a Ponzi scheme case like *Madoff*, the initial transferee’s lack of good faith requires giving back all transfers within two years of bankruptcy, not just net winnings.

Under Section 550(b)(1), a subsequent transferee is entitled to retain the transferred property if the subsequent transferee took “for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided.” Section 550(b)(1) is applicable only to subsequent transferees.

In his complaint, the Madoff trustee alleged facts aiming to show that the three defendants all undertook investigations leading them to suspect that Madoff was conducting a fraud. For District Judge Rakoff, however, the allegations did not rise to the level of willful blindness.

The Reversal on Willful Blindness

Circuit Judge Richard C. Wesley reversed on willful blindness.

He defined inquiry notice as arising when “the facts the transferee knew would have led a reasonable person in the transferee’s position to conduct further inquiry into a debtor-transferor’s possible fraud.”

In comparison, District Judge Rakoff required willful blindness, which he defined as “a showing that the defendant acted with willful blindness to the truth, that is, he intentionally chose to blind himself to the red flags that suggest a high probability of fraud.”

Judge Wesley explained that the two standards differ in “degree and intent.” Someone who is willfully blind takes deliberate action to avoid confirming a high probability of wrongdoing. Inquiry notice, on the other hand, requires “knowledge of suspicious facts” that would induce “a reasonable person to investigate.”

District Judge Rakoff had invoked willful blindness because it is the standard for some securities law claims, and SIPA is part of securities law.

The Bankruptcy Code does not define “good faith,” so Judge Wesley looked to the “commonly understood meaning.” Before the Bankruptcy Code, he said that “good faith” meant “inquiry notice,” citing Circuit Judge Learned Hand for using that standard in 1914.

Judge Wesley concluded that “the plain meaning of good faith in Sections 548 and 550 of the Bankruptcy Code embraces an inquiry notice standard.” Other circuits, he said, “unanimously accept the inquiry notice standard.”

“The historical usage of the phrase ‘good faith’ (particularly as used in the context of fraudulent conveyance law), this Court’s prior case law, and the legislative history of the Bankruptcy Code all lead us to reject the heightened willful blindness standard,” Judge Wesley said.

The Same Standard in SIPA Cases

The defendants contended that willful blindness obtains in SIPA cases because inquiry notice is inconsistent with the standard in federal securities law.

Judge Wesley rejected the argument, observing that it had not been adopted by any other circuit court. He noted, among other things, that a Section 10(b) suit “for securities fraud is meaningfully different from a SIPA liquidation.”

The Burden of Pleading

Although good faith is an affirmative defense that the defendant must plead in an answer under Rule 8(c), District Judge Rakoff had placed the burden on the Madoff trustee in view of the “policy goals” of a SIPA liquidation.

Judge Wesley held that “the trustee is not required to plead a transferee’s lack of good faith” because “good faith is an affirmative defense under Sections 548 and 550 and . . . SIPA does not compel departing from the well-established burden-of-pleading rules.”

Other circuits, Judge Wesley said, “uniformly agree,” along with the *Collier* treatise. He found no “policy-based justifications for departing from Rule 8(c)(1) because placing the burden on the defendant “does not contradict the goals of SIPA.”

Judge Wesley vacated the judgments of the bankruptcy court and remanded for further proceedings.

The Concurrence

Circuit Judge Steven J. Menashi wrote separately.

He said that using “fraudulent transfer law rather than the law relating to preferences to promote an equal distribution among creditors . . . is questionable.” Because none of the defendants had challenged the Ponzi scheme presumption, he concurred in Judge Wesley’s opinion.

This writer finds the concurrence difficult to follow. Judge Menashi may have been saying that the defendants’ liability should have been judged by whether or not the transfers were preferences, had the defendants made the argument. To read the concurrence, [click here](about:blank).

Observations

The Second Circuit had reversed District Judge Rakoff two years ago by holding that Sections 548 and 550 can be applied extraterritorially to recover fraudulent transfers even if subsequent transfers occurred abroad. *In re Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC*, 917 F.3d 85 (2d Cir. Feb. 25, 2019). To read ABI’s report, [click here](about:blank).

The rulings by District Judge Rakoff on good faith set back the Madoff trustee even more in his efforts to recover on behalf of defrauded investors. More than five years into the liquidation, the decision by Judge Rakoff seemingly killed off about 90 lawsuits aiming to recover about $3.75 billion.

Rather than settle for little or nothing in the face of unfavorable decisions by District Judge Rakoff, the Securities Investor Protection Corp. supported the trustee’s decision to undertake seven years of further litigation to set up the test cases in the Second Circuit.

Already, the Madoff trustee has recovered almost $14.5 billion and has distributed more than $13.5 billion. He holds more than $900 million. The distributions so far represent almost 70% of investors’ cash losses.

[The opinion is](about:blank) *Picard v. Citibank NA (In re Bernard L. Madoff Investment Securities LLC)*, 20-1333, 2021 BL 326779, 2021 Us App Lexis 26100 (2d Cir. Aug. 30, 2021).

#### *Properly structuring a leveraged refinancing in the Second Circuit can avoid attack as a fraudulent transfer despite the Supreme Court’s effort at narrowing the ‘safe harbor.*’

# Affirmance Shows that *Merit Management* Has Been Gutted in the Second Circuit

Affirming the bankruptcy court, a district judge in New York handed down a decision seeming to mean that a leveraged transaction cannot be set aside in the Second Circuit as a fraudulent transfer if the professionals properly structure the transaction to invoke the so-called safe harbor in Section 546(e).

If followed elsewhere, the September 13 decision by District Judge George B. Daniels allows the structuring of a transaction to avoid the consequences of Merit Management Group LP v. FTI Consulting Inc., 138 S. Ct. 883 (Sup. Ct. Feb. 27, 2018). There, the Court held that the presence of a financial institution as a conduit in the chain of payments in a leveraged buyout was insufficient to invoke the safe harbor in Section 546(e). That section provides that a trustee may not avoid a “settlement payment . . . made by or to (or for the benefit of) . . . a financial institution.”

Merit Management held that Section 546(e) only applies to “the transfer that the trustee seeks to avoid.” More particularly, Justice Sonia Sotomayor said that “the relevant transfer for purposes of the Section 546(e) safe-harbor inquiry is the overarching transfer that the trustee seeks to avoid.” *Id*. at 888, 893.

The Leveraged Recapitalization

At the risk of oversimplification, the highly complex leveraged recapitalization worked like this:

The operating company borrowed about $1 billion by taking down new credit facilities secured by its assets. The operating company transferred the loan proceeds to a bank account of its parent holding company. The holding company had no assets other than ownership of the operating company.

The holding company then transferred the loan proceeds to a second bank, which distributed the funds to equity holders in redemption of their warrants and equity interests and to pay a dividend.

More than three years later, the operating company was in chapter 11. The plan paid only the first-lien lender. Subordinate lenders, owed hundreds of millions of dollars, received nothing more than the right to distributions from whatever the liquidating trustee could recover in lawsuits.

The liquidating trustee filed a fraudulent transfer suit under state law, alleging that the operating company was insolvent at the time of the leveraged restructuring. Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., granted the defendants’ motion for summary judgment. *Holliday v. K Road Power Management LLC (In re Boston Generating LLC)*, 617 B.R. 442 (Bankr. S.D.N.Y. June 18, 2020). To read ABI’s report, [click here](about:blank).

Where Judge Grossman needed 82 pages to dismiss, Judge Daniels affirmed in only 20 pages.

The Relevant Transaction

On appeal, the trustee argued that the relevant transfer under *Merit Management* was the initial transfer from the operating company to the holding company’s first bank account. Under the trustee’s theory, the safe harbor would not come into play because the first transfer was not in connection with a settlement payment for securities.

Judge Daniels disagreed. In substance, he compressed the first two transfers into one. In other words, the relevant transfer put the loan proceeds into the hands of a financial institution that made the distributions to equity holders. The transfer was a settlement payment that invoked the safe harbor.

Furthermore, Judge Daniels said, the parent holding company was a financial institution itself protected by the safe harbor. Why, you say?

In Section 101(22), a non-financial institution becomes a financial institution if a financial institution is acting as its agent. In the case on appeal, Judge Daniels decided as a matter of common law that a bank was serving as the holding company’s agent, thus making the holding company a financial institution itself protected by the safe harbor.

Bound by Second Circuit authority from Note Holders v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litigation), 818 F.3d 98 (2d Cir. 2016), Judge Daniels also upheld the ruling by Judge Grossman that the safe harbor in Section 546(e) preempted the trustee’s fraudulent transfer claims under state law.

[The opinion is](about:blank) *Holliday v. Credit Suisse Securities (USA) LLC*, 20-5404, 2021 BL 344979 (S.D.N.Y. Sept. 13, 2021).

#### Judge in New Jersey explains why chapter 11 is the best alternative for a large company to deal with mass torts.

# Johnson & Johnson Survives a Motion to Dismiss that Alleged a Bad Faith Filing

The Johnson & Johnson entity named LTL Management LLC survived a motion to dismiss its chapter 11 case originally filed in North Carolina, in an opinion on February 25 by Chief Bankruptcy Judge Michael B. Kaplan of Trenton, N.J.

Judge Kaplan’s 54-page opinion is a ringing endorsement of chapter 11 as the best alternative in the state and federal legal systems for dealing with mass torts. He found no fault with J&J’s use of the so-called Texas Two-Step to avoid putting the entire enterprise in chapter 11.

Judge Kaplan said he had “little trouble finding that the chapter 11 filing serves to maximize the property available to satisfy creditors by employing the tools available under the Bankruptcy Code to ensure that all present and future tort claimants will share distributions through the court-administered claims assessment process.”

Compared to the tort system, Judge Kaplan said that chapter 11 represents “a more beneficial and equitable path toward resolving Debtor’s ongoing talc-related liabilities.” For the reasons expressed in his opinion, Judge Kaplan developed “a strong conviction that the bankruptcy court is the optimal venue for redressing the harms of both present and future talc claimants in this case — ensuring a meaningful, timely, and equitable recovery.”

In reaching his decision, Judge Kaplan was not blind to recent criticism of the bankruptcy system. He said,

There is no question that, over time, our bankruptcy courts have witnessed serious abuses and inefficiencies, striking at the heart of the integrity of our bankruptcy courts. For instance, the approval of overly broad nonconsensual third-party releases, and the propriety/necessity for twenty-four hour accelerated bankruptcy cases have drawn deserved scrutiny. Likewise, the selection of case venue, as in the matter at hand, has warranted critical attention and debate.

Refusing to dismiss the case after a five-day trial, Judge Kaplan said that the chapter 11 filing “is unquestionably a proper purpose under the Bankruptcy Code.” Still, he had “no expectation that this decision will be the final word on the matters.”

Corporate Restructuring & Venue

Just before the chapter 11 filing, Johnson & Johnson created two new subsidiaries. LTL was created to be the debtor, and the other took over J&J’s operating businesses.

The debtor was first created as a limited liability company in Texas and converted to a North Carolina limited liability company. On October 14, two days later, the debtor filed a chapter 11 petition in Charlotte.

The debtor was given no business operations of its own but assumed liability for all talc-related claims. The debtor was given some non-operating assets and insurance receivables, plus $6 million in cash. The debtor was also the beneficiary of a so-called funding agreement where the other J&J businesses agreed to supply the funds necessary for emerging from chapter 11, up to about $60 billion, representing the value of the businesses at the time of the restructuring.

In an opinion on November 16, Bankruptcy Judge J. Craig Whitley transferred venue to New Jersey, where the case was assigned to Judge Kaplan. To read ABI’s report on the venue opinion, [click here](https://www.abi.org/newsroom/daily-wire/johnson-johnson-venue-transferred-from-north-carolina-to-new-jersey).

The official committee representing talc claimants filed a motion to dismiss the chapter 11 case under Section 1112(b), contending that the filing was in bad faith. The U.S. Trustee supported either dismissal or appointment of a chapter 11 trustee.

J&J’s Financial Distress

Judge Kaplan laid out J&J’s financial problems resulting from the 38,000 talc-related lawsuits that have been filed so far, not to mention tens of thousands more that would be filed in the future as cancers manifest themselves.

Judge Kaplan mentioned one case where the jury awarded an individual claimant $4.69 billion that was affirmed on appeal but reduced to $2.25 billion. Based on awards stemming so far from litigation, he roughly calculated liability as exceeding $15 billion, “not including the tens of thousands of ovarian cancer claims and all future cancer claims.”

In sum, Judge Kaplan said that the tort system outside of bankruptcy would result in judgments in favor of a few claimants exhausting all of the value in J&J, leaving nothing for the vast majority of claimants.

The debtor itself said that the corporate restructuring before bankruptcy and the chapter 11 filing together were designed to “globally resolve talc-related claims through a chapter 11 reorganization without subjecting the entire [J&J business] to a bankruptcy proceeding.”

Applying the Facts to the Law

Arguing for dismissal, talc claimants noted that the debtor had no creditors (aside from talc claimants), no lenders, no customers and no suppliers. They said the bankruptcy had no business purpose but was designed to shed tort liability without subjecting the J&J business to the rigors and inconveniences of chapter 11.

The talc claimants, according to Judge Kaplan, argued that the bankruptcy strategy was “intended to force talc claimants to face delay and to secure a ‘bankruptcy discount’; in Movants’ words, ‘an obvious legal maneuver to impose an unfavorable settlement dynamic on talc victims.’”

To decide whether the bankruptcy strategy justified dismissal for cause under Section 1112(b), Judge Kaplan said that the good faith inquiry examines “the totality of the circumstances.” The general focus, he said, is whether the petition serves a valid bankruptcy purpose or was filed “merely to obtain a tactical litigation advantage.”

Valid Reorganization Purpose

Judge Kaplan found a valid reorganization purpose because bankruptcy is the only method to “ensure that all present and future tort claimants will share distributions through the court-administered claims assessment process.”

In the Third Circuit, Judge Kaplan said, there must be “some” degree of financial distress to underpin a valid business purpose. In that respect, he said,

No public or private company can sustain operations and remain viable in the long term with juries poised to render nine and ten figure judgments, and with such litigation anticipated to last decades going forward.

Judge Kaplan said that J&J “need not have waited until its viable business operations were threatened past the breaking point.”

In reaching his conclusion on valid business purpose, Judge Kaplan examined what he called “a far more difficult issue”: whether there was “a more beneficial and equitable path toward resolving Debtor’s ongoing talc-related liabilities.” In that regard, he said he “simply cannot accept the premise that continued litigation in state and federal courts serves best the interest of [the tort lawyers’] constituency.”

Class actions, Judge Kaplan said, are usually not suitable for mass tort cases. Likewise, multidistrict litigation would produce a few bellwether trials, “at best.” Thereafter, 40,000 tort cases would be sent to district courts for trials throughout the country, where the same issues would be relitigated over and over.

By contrast, Judge Kaplan said that chapter 11 invokes Section 524(g) to “ensure[] that present claimants do not exhaust the debtor’s assets before future claimants have even manifested injuries.” The tort system, on the other hand, “produces an uneven, slow-paced race to the courthouse, with winners and losers.” It was “folly,” he said, to say that “the tort system offers the only fair and just pathway of redress.”

Unfair Tactical Advantage

With regard to the claim that J&J invoked bankruptcy to obtain an unfair tactical advantage, Judge Kaplan found “no improprieties or failures to comply with the Texas statute’s requirements.” He added, “the interests of present and future talc litigation creditors have not been prejudiced.” He found “nothing inherently unlawful or improper with application of the Texas divisional merger scheme.”

Judge Kaplan was “not prepared to rule that use of the statute as undertaken in this case, standing alone, evidences bad faith.”

With regard to other aspects of good faith, Judge Kaplan said that the funding agreement “will be available upon confirmation of a plan — whether or not the plan is acceptable to [the debtor or J&J], and whether or not the plan offers payors protections under § 524(g).”

Had there been no reorganization to exclude the operating business from chapter 11, Judge Kaplan said,

[S]uch filings would pose massive disruptions to operations, supply chains, vendor and employee relationships, ongoing scientific research, and banking and retail relationships — just to name a few impacted areas. The administrative and professional fees and costs associated with such filings would likely dwarf the hundreds of millions of dollars paid in mega cases previously filed — and for what end?

It was not, Judge Kaplan said, “a case of too big to fail . . . rather, this is a case of too much value to be wasted, which value could be better used to achieve some semblance of justice for existing and future talc victims.”

“The potential loss in market value, the disruptions to operations, and the excessive administrative costs associated with independent chapter 11 filings,” Judge Kaplan said, “justify the business decision to employ the divisional merger statute as a means of entering the bankruptcy system.” Bankruptcy, he said, “may indeed accelerate payment to cancer victims and their families.”

In sum, it would be fair to say that Judge Kaplan found that bankruptcy confers benefits on the bulk of existing and future claimants and was not designed to gain an unfair litigation advantage.

The Remedy

Judge Kaplan denied the motion to dismiss and said that the record did not support the appointment of a chapter 11 trustee. He nonetheless agreed “that there is a need for independent scrutiny of possible claims while the case progresses through the appointment of a Future Talc Claims Representative, mediation and towards the plan formulation process.”

Judge Kaplan said he would take up questions about a future claimants’ committee and mediation at the omnibus hearing on March 8.

[The opinion is](https://abi-opinions.s3.amazonaws.com/J%26J+Dismissal.pdf) *In re LTL Management LLC*, 21-30589 (Bankr. D.N.J. Feb. 25, 2022).

### Executory Contracts & Leases

#### Unsuccessfully attempting to punch homes in Mirant, FERC emerged from the Fifth Circuit with no power to stop bankruptcy courts from rejecting contracts otherwise within FERC’s jurisdiction.

# Invoking *Mirant*, Fifth Circuit Permits Rejection of a Gas Pipeline Contract

The Fifth Circuit reaffirmed its *Mirant* decision from 2004 by holding that the bankruptcy court has power to reject a filed-rate contract with a natural gas pipeline without authorization from FERC, the Federal Energy Regulatory Commission.

Bound by *Mirant*, Circuit Judge Carolyn Dineen King said in her March 14 opinion that the “pitched battle” mounted by FERC was actually “a settled truce.” *Mirant*, she said, “holds that a bankruptcy court can authorize rejection of a filed-rate contract, and that, post-rejection, FERC cannot require continued performance on the rejected contract.”

The Gas Pipeline Contract

The debtor was a producer of oil and natural gas. The debtor had a seven-year contract to transport the gas it produced through a particular pipeline. The contract called for the debtor to pay the pipeline owner $169 million over the life of the contract, whether or not the debtor shipped any natural gas.

In chapter 11, the debtor moved to reject the pipeline contract, having stopped producing natural gas. FERC objected, contending that its approval was required before the bankruptcy court could reject. Even if the contract were rejected, FERC argued that the debtor was obligated to pay rejection damages in full, not with the discount afforded by the plan. FERC also objected to confirmation of the debtor’s chapter 11 plan.

Bankruptcy Judge Marvin Isgur authorized rejection of the pipeline contract and confirmed the plan. FERC appealed, and the Fifth Circuit accepted a direct appeal, overstepping an intermediate appeal to the district court.

*Mirant* and the Dueling Regulatory Schemes

Judge King characterized the appeal as “a clash of two congressionally constructed titans, FERC and the bankruptcy courts.” FERC, she said, has exclusive jurisdiction over the interstate transportation of natural gas. Rates approved by FERC cannot be modified or abrogated without the commission’s consent.

Judge King made the following points about *In re Mirant Corp.*, 378 F.3d 511 (5th Cir. 2004):

* The case dealt with an electricity-purchase agreement. The bankruptcy court allowed rejection, but the district court reversed, believing that FERC’s approval was required. The circuit reversed the district court.
* Although FERC has jurisdiction over the modification of rates, *Mirant* said that rejection was a breach, not a change in a filed rate.
* The rejection power, *Mirant* said, does not contain an exception for power contracts like it does for union contracts.
* *Mirant* rejected the idea that the debtor must pay the full amount of rejection damages and not with the bankruptcy discount afforded by the plan.
* Rejection can be accompanied by an injunction aimed at FERC, but is limited to prohibiting FERC from compelling performance under the rejected contract.
* Akin to the rejection of a union contract, the bankruptcy court must apply a more rigorous standard considering public interest and the disruption of energy supplies.
* Rejection is not a collateral attack on the filed rate because the filed rate forms the basis for fixing rejection damages.

*Mirant* Controls

Bound by *Mirant*, Judge King said that “a bankruptcy court can authorize rejection of a filed-rate contract, and that, post-rejection, FERC cannot require continued performance on the rejected contract.” She dismissed FERC’s argument that many of the statements in *Mirant* were *dicta*, not holding. Everything in *Mirant* pertinent to the case on appeal was necessary to the decision in *Mirant*.

Judge King noted that the Sixth Circuit concurred with *Mirant* in *In re FirstEnergy Solutions Corp.*, 945 F.3d 431 (6th Cir. 2019). To read ABI’s report on *FirstEnergy*, [click here](https://www.abi.org/newsroom/daily-wire/sixth-circuit-gives-primacy-to-the-bankruptcy-court-in-rejecting-power-contracts). [Note: *FirstEnergy* was a 2/1 decision in the Sixth Circuit.]

Applying Mirant to the case on appeal, Judge King said,

Given that it is clear that the challenged language in *Mirant* is binding, the result of this case is straightforward. A district court (and, by extension, a bankruptcy court) has the ‘power . . . to authorize rejection of’ a filed-rate contract . . . .

Judge King added that rejection was not a collateral attack on the filed rate, because the filed rate would be the basis for fixing the pipeline’s rejection damages. Furthermore, she said, the debtor was “not just seeking to secure a lower rate, but instead wants out of the contract altogether, given the suspension of its drilling program.”

The bankruptcy court, Judge King said, had not allowed rejection under the business-judgment standard but had “explicitly considered the public interest.”

Judge King said that the bankruptcy court had properly invited FERC to participate in the rejection proceedings as a party-in-interest. She declined “to expand beyond our dictates in *Mirant* by requiring a bankruptcy court to halt its progress and allow FERC to hold a hearing on the public-interest ramifications of the rejection of a filed-rate contract.”

Judge King ended her decision by saying there was no violation of Section 1129(a)(6), which requires governmental regulatory approval of rate changes. She said there was no rate change because rejection damages would be based on the filed rate.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Ultra+Pet.pdf) *FERC v. Ultra Resources Inc. (In re Ultra Resources Corp.)*, 20-20623 (5th Cir. March 14, 2022).

#### An irrevocable surety bond isn’t executory because it gives the bonding company no further obligations to the debtor.

# Surety Bonds Aren’t Executory Contract and Can’t Be Assumed, District Judge Says

Affirming Bankruptcy Judge Douglas D. Dodd of Baton Rouge, La., the district court held that a surety bond is not an executory contract that a debtor can assume.

The surety may have been lulled into complacency during the chapter 11 case by the debtor’s having said it would continue paying the bonds. Just like Judge Dodd, District Judge Brian A. Jackson held that a surety bond is not an executory contract capable of assumption under the so-called Countryman definition of executory contracts.

The E&P Bonds

The debtor was engaged in oil and gas exploration and production. Before bankruptcy, the debtor had acquired four irrevocable performance bonds securing the debtor’s obligations to the state for environmental liabilities and for plugging and abandoning wells. The bonds were accompanied by an indemnity agreement where the debtor agreed to indemnify the bonding company if it were called on the bonds.

The insurer was liable for a maximum of about $10.6 million on the bonds, Bankruptcy Judge Dodd said in his opinion on Sept. 22, 2020. At filing, the insurer held some $3.2 million in cash to secure the bonding company’s obligations were claims to be made on the bonds. *See In re Falcon V LLC*, 620 B.R. 256 (Bankr. M.D. La. Sept. 22, 2020). To read ABI’s report, [click here](about:blank).

The bonding company filed a secured claim for $3.2 million and an unsecured claim for the difference, $7.4 million. In the claim, the insurer said that the bonds were financial accommodations that the debtor could not assume or assign.

The Confirmed Plan

On motion of the debtor near the outset of reorganization, the bankruptcy court authorized the debtor to “continue and maintain” the surety bonds and to pay obligations under the bonds as they came due. Later, the disclosure statement said the debtor would “maintain” the bonds after confirmation. The plan said that executory contracts were deemed assumed unless they were listed for rejection, but the bonds were not on the list of rejected executory contracts.

After confirmation, the debtor failed to pay a premium on the bonds. The bonding company responded by demanding more collateral. The debtor refused, accusing the bonding company of violating the discharge injunction.

To resolve the dispute, the bonding company filed a motion for a declaration that the bonds were among executory contracts assumed automatically on confirmation.

Bankruptcy Judge Dodd agreed with the debtor. He held that the bonds were not executory contracts capable of assumption. And if they were executory, he said they were financial accommodations incapable of assumption.

The bonding company appealed, to no avail.

Countryman Ends the Discussion

The outcome turned on Section 365(a), which permits the assumption of an executory contract with the court’s permission. “Curiously,” Judge Jackson said, the statute does not define “executory contract.”

Judge Jackson prefaced his analysis of the law by recognizing that the Fifth Circuit has adopted the definition of executory contracts proposed by Prof. Vern Countryman of Harvard Law School. The professor called a contract executory if it is “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.” *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

The key to the outcome was contained on the second page of Judge Jackson’s opinion. He said that the indemnity imposed continuing obligations on the debtor but none on the bonding company.

“Under any stretch” in applying the Countryman definition, Judge Jackson said that the bonding company “owes *no* additional performance to the Reorganized Debtors after posting the surety bonds.” The bonding company’s “only remaining duty is a contingent obligation” to the beneficiaries of the bonds.

Even “more problematic,” Judge Jackson said, the bonds are “irrevocable.”

“Thus,” he said, “the Reorganized Debtors failure to perform does *not* create a material breach that excuses [the bond company’s] performance, as required by the second prong of the Countryman test.”

Governed by the Fifth Circuit’s adoption of the Countryman test, Judge Jackson said he would rule, as he “must,” that the bonds were not executory contracts and thus were incapable of assumption.

Judge Jackson upheld the ruling by Judge Dodd and, in the process, said that surety bonds cannot pass unaffected through bankruptcy because the ride-through doctrine applies only to executory contracts that were neither assumed nor rejected.

[The opinion is](about:blank) *Argonaut Ins. Co. v. Falcon V LLC*, 20-00702 (M.D. La. Sept. 30, 2021).

### Venue, Jurisdiction & Power

#### The U.S. Trustee is not the better or the only party to uphold the integrity of the bankruptcy court, the Second Circuit holds.

# Second Circuit Expands Standing to Ensure Integrity of the Bankruptcy Court

Although written in the context of a RICO suit, language in a Second Circuit opinion seems to mean that a creditor who otherwise might not have standing would have standing to pursue litigation “to ensure the integrity of the Bankruptcy Court.”

The Second Circuit handed down its opinion on January 19 reversing the district court, which had dismissed a lawsuit brought by Jay Alix against consulting firm McKinsey & Co. Inc. under the Racketeer Influenced and Corrupt Organizations Act, or RICO.

The Allegations

Jay Alix was the founder of AlixPartners LLP, a bankruptcy consulting firm. As the assignee of the firm, Alix sued McKinsey and some of its officers in federal district court in New York under RICO. Alix alleged that his firm and three others along with McKinsey were retained as consultants in most of the country’s so-called mega chapter 11 cases.

Alix alleged that his firm and three others had been retained in 75% of the cases in which McKinsey was not the court-retained bankruptcy consultant. Among the assignments that did not go to McKinsey, Alix alleged that his firm captured 24%.

The complaint alleged that McKinsey failed to disclose connections under Sections 327(a) and 101(14) that would have made the firm not disinterested and would have disqualified the firm from being retained in 13 cases. Alix alleged that his firm would been retained in some of those 13 cases had McKinsey been disqualified.

Alix also alleged that McKinsey had been engaged in a so-called pay-to-play scheme.

The district court granted McKinsey’s motion to dismiss under Rule 12(b)(6). The district court reasoned that the allegations in the complaint were insufficient to satisfy RICO’s proximate cause requirement.

The Second Circuit reversed the dismissal in a 31-page opinion by Circuit Judge Barrington D. Parker.

Special Standing Rules for Bankruptcy Integrity

To prove a RICO claim, the complaint must show a violation of RICO, an injury to the plaintiff’s business and that the injury was caused by the RICO violation. “This appeal implicates the causation requirement,” Judge Parker said.

The district judge believed that the injury to Alix had been caused by the debtors’ decisions not to hire AlixPartners and not by McKinsey’s alleged misconduct. The district judge also believed that the U.S. Trustee would have been the better plaintiff to remedy the alleged misconduct.

Disagreeing, Judge Parker said that the district court had “conflated proof of causation and proof of damages and that it did not draw all reasonable inferences in Alix’s favor.”

Here’s the important bankruptcy angle:

“More importantly,” Judge Parker said, “the district court gave insufficient consideration to the fact that McKinsey’s alleged misconduct targeted the federal judiciary.”

Judge Parker expanded on the idea, suggesting that litigants who can’t show direct harm to afford standing may nonetheless pursue litigation when the integrity of the process is at stake. He said:

[T]his case requires us to focus on the responsibilities that Article III courts must shoulder to ensure the integrity of the Bankruptcy Court and its processes. Litigants in all of our courts are entitled to expect that the rules will be followed, the required disclosures will be made, and that the court’s decisions will be based on a record that contains all the information applicable law and regulations require. If McKinsey’s conduct has corrupted the process of engaging bankruptcy advisors, as Alix plausibly alleges, then the unsuccessful participants in that process are directly harmed.

Later, Judge Parker said that “fraud on the Bankruptcy Court committed in the manner alleged by Alix causes direct harm to litigants who are entitled to a level playing field and calls into play our unique supervisory responsibilities.”

Judge Parker went on to explain why Alix had “plausibly alleged proximate cause with respect to all thirteen engagements.” He said there was “also a reasonable inference that, in making another selection [of a consultant had McKinsey been disqualified, the chapter 11 debtors] would likely have awarded assignments to eligible firms in approximately the same ratio they had been using in the past.”

To the idea that the U.S. Trustee would have been a better plaintiff, Judge Parker said he was “not persuaded that the Bankruptcy Court or the U.S. Trustee, which McKinsey argues would be a more appropriate alternative plaintiff, would be in a position to gather information about McKinsey’s conduct were Alix not in the picture.”

Likewise, he was “not persuaded that, under the circumstances presented here, either the Bankruptcy Court or the U.S. Trustee would be in a superior position to find out what McKinsey did (or did not do).”

Judge Parker also reversed dismissal of Alix’s pay-to-play claim under 18 U.S.C  152(6), which proscribes fraudulently offering money to act or forbear from acting in a bankruptcy case. He said it was “implausible — indeed inconceivable — that any Bankruptcy Court would have approved McKinsey’s retention if Alix’s allegations were substantiated.”

Because Judge Parker was reversing a motion to dismiss, he said that “McKinsey might well prevail on summary judgment or at trial, and to be sure, uncertainties at those stages might exist.”

In the same vein, D.J. Carella, a spokesperson for McKinsey, said in a statement that the “decision solely addresses technical pleading standards and not whether Mr. Alix’s claims are true. To date, Mr. Alix has lost all six of his lawsuits against McKinsey, and we are confident the evidence will ultimately show that this lawsuit is similarly meritless.”

Although not in lawsuits with Alix, the U.S. Trustee Program issued a press release in February 2019 about a settlement where McKinsey agreed to pay $15 million for inadequate disclosure in three chapter 11 cases. In December 2020, the U.S. Trustee Program issued a press release about a separate settlement made in connection with a case in Texas where McKinsey agreed to withdraw its application for retention and waive the recovery of fees for work it had performed. The press release said that the fees and expenses “likely” would have been “millions of dollars.”

The Circuit Split

To establish appellate standing, courts require the appellant to be a “person aggrieved.” The Second Circuit’s opinion reignites a circuit split.

Alix previously argued in a petition for *certiorari* that the Second, Third, Sixth and Eleventh Circuits recognize an exception to the pecuniary interest requirement. They hold, he argued, that the public interest may also create a sufficient stake in the outcome to confer appellate standing.

On the other hand, Alix argued to the Supreme Court that the Fourth, Fifth and Seventh Circuits do not recognize the public interest exception to the pecuniary interest test. The Supreme Court denied *certiorari* in *Mar-Bow Value Partners LLC v. McKinsey Recovery & Transformation Services US LLC*, 139 S. Ct. 1601, 203 L. Ed. 2d 755 (Sup. Ct.) (*cert. den.* April 22, 2019).

Alix was in the Supreme Court because the Fourth Circuit had upheld dismissal of another lawsuit against McKinsey where the district court concluded that Alix would not have benefitted monetarily. To read ABI’s stories on the petition for *certiorari*, click [here](https://www.abi.org/newsroom/daily-wire/the-jay-alixmckinsey-spat-reaches-the-supreme-court) and [here](https://www.abi.org/newsroom/daily-wire/supreme-court-won%E2%80%99t-intervene-in-fight-between-jay-alix-and-mckinsey).

[The opinion is](https://abi-opinions.s3.amazonaws.com/Alix+v+McKinsey+2+Cir.pdf) *Alix v. McKinsey & Co. Inc.*, 20-2548 (2d Cir. Jan. 19, 2022).

#### The Eleventh Circuit explained how prudential (or ‘person aggrieved’) standing is a higher standard more difficult to meet than constitutional (or ‘Article III’) standing.

# Target of Lawsuit Doesn’t Have Standing to Appeal a Litigation Funding Agreement

The target of a lawsuit financed by a litigation funding agreement has neither Article III standing nor prudential standing in the Eleventh Circuit to appeal the bankruptcy court’s order authorizing the funding.

The corporate debtor’s confirmed chapter 11 plan created a litigation trust, whose trustee sued the debtor’s bank for aiding and abetting a breach of fiduciary duty and to recover an allegedly $3 million fraudulent transfer.

Lacking funds to prosecute the suit, the liquidating trustee negotiated a litigation funding agreement with the debtor’s principal. Significantly, the trustee retained the power to settle or make settlement offers. However, the trustee was required to confer in good faith with the funder.

According to the Eleventh Circuit’s *per curiam* opinion on March 31, there evidently was animus between the bank and the debtor’s principal, who had threatened to sue the bank if it did not withdraw objections made to state insurance regulators.

The bank opposed approval of the funding agreement, arguing that the debtor’s principal could improperly influence settlement. The circuit court characterized the bank as claiming to preserve the fairness of the bankruptcy proceedings.

The bankruptcy court approved the funding agreement. The district court dismissed the bank’s appeal for lack of appellate standing. Reviewing the district court’s standing decision *de novo*, the Eleventh Circuit affirmed.

The circuit court separately addressed the bank’s dual hurdles: Article III (or “constitutional”) standing, and prudential (or “person aggrieved”) standing. Prudential standing is the higher standard that an appellant must meet.

To establish constitutional standing under Article III, the litigant must show injury in fact, causation and redressability, the circuit court said. Furthermore, the injury must be concrete and particularized, not conjectural or hypothetical. In addition, the injury must be “certainly impending.” Possible future injury won’t cut the mustard.

The appeals court said that the appellant must “at least demonstrate that he is in immediate danger of sustaining a direct injury, meaning that the anticipated injury must occur within a fixed time period in the future.”

Applying the standards to the case on appeal, the appeals court said that the bank’s “alleged injury is not imminent, and is instead based on a speculative, highly attenuated, chain of possibilities.”

The circuit court noted that no settlement offer had been made in the lawsuit. Indeed, discovery had not even begun. For there to be injury, there would need to be a settlement offer where the trustee, although having retained settlement authority, would have acquiesced improperly in the lender’s exhortations.

Because injury to the bank was “clearly based on a highly attenuated chain of possibilities,” the appeals court held that the bank lacked constitutional standing.

Turning to prudential standing to appeal, the circuit court said that the “person aggrieved” test “restricts a plaintiff’s standing more than Article III.” The appellant must be directly, pecuniarily and adversely affected by the bankruptcy court’s order.

Hoping to avoid liability in a lawsuit, the appeals court said, does not make a party “aggrieved,” because “orders allowing litigation to continue do not burden a party’s ability to defend against liability.”

Furthermore, the circuit court said that a party is not aggrieved unless “the interest he seeks to validate is not protected or regulated by the Bankruptcy Code.” In the case on appeal, the court said that the bank’s “interest in avoiding liability is ‘antithetical to the goals’ of the Bankruptcy Code.”

“Finally,” the appeals court said, the bank did “not meet the ‘person aggrieved’ doctrine simply by virtue of attacking the inherent fairness of the bankruptcy proceedings.”

The Eleventh Circuit upheld dismissal of the appeal. Even if the bank had constitutional standing, it lacked “person aggrieved” standing.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Westport+Holdings.pdf) *Valley National Bank v. Warren (In re Westport Holdings Tampa Ltd.)*, 21-11767 (11th Cir. March 31, 2022).

#### The Ninth Circuit answered a question left open by the Supreme Court in Ritzen.

# Denial of Stay Modification *Without* Prejudice Can Be Final, Ninth Circuit Says

Reaching an issue the Supreme Court left undecided in *Ritzen*, the Ninth Circuit held that denial of a stay-relief motion *without* prejudice can still be a final, appealable order.

The appeals court looked beyond the “without prejudice” label placed on the order by the bankruptcy court to decide whether denial of the motion meant that the creditor would not have stay relief for the purpose sought by the creditor.

Reversing the district court, which had believed that the order was not appealable, the panel majority reached the merits and upheld the bankruptcy court’s denial of stay relief.

Stay-Relief Motion Denied

The debtor and a creditor had been embroiled in litigation in Massachusetts state court for seven years, trading claims and counterclaims about breach of fiduciary duty and fraudulent misrepresentation. One week before a jury trial was to begin in Massachusetts, the debtor-defendant filed a chapter 7 petition in California.

The creditor filed a $2 million claim in bankruptcy court, a complaint in bankruptcy court to bar discharge of the debt and a companion motion to modify the automatic stay. The creditor reasoned in the lift-stay motion that the Massachusetts court was familiar with the case and could resolve all questions about the validity of the claim and facts indicating whether the claim was dischargeable.

Originally inclined to modify the stay, the bankruptcy court ultimately denied the motion without prejudice.

The district court denied the creditor’s motion for leave to appeal an interlocutory order. The creditor appealed to the circuit.

The Ninth Circuit panel handed down two decisions on March 8. One decision unanimously reversed the district court by holding that lift-stay denial was a final, appealable order. In the second opinion, all three judges found reason to rule on the merits. Over a dissent, two judges in the second opinion upheld denial of the lift-stay motion.

Lift-Stay Denial Was Appealable

In his precedential opinion on finality, Circuit Judge A. Wallace Tashima began by citing *Ritzen Group, Inc. v. Jackson Masonry, LLC*, 140 S. Ct. 582 (2020), where the Supreme Court held that an order denying a stay-relief motion is final and appealable when it “conclusively resolve[s] the movant’s entitlement to the requested relief.” *Id.* at 591. Citing *Bullard v. Blue Hills Bank*, 575 U.S. 496, 501 (2015), the Supreme Court went on to say that “[o]rders in bankruptcy cases qualify as ‘final’ when they definitively dispose of discrete disputes within the overarching bankruptcy case.” *Id.* 586.

In *Ritzen*, Judge Tashima said that the Supreme Court “did ‘not decide whether finality would attach to an order denying stay relief if the bankruptcy court enters it “without prejudice” because further developments might change the stay calculus.’” *Id.* at 592, n.4. To read ABI’s report on *Ritzen*, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-rules-that-%E2%80%98unreservedly%E2%80%99-denying-a-lift-stay-motion-is-appealable).

Confronting the question left undecided in *Ritzen*, Judge Tashima said, “We address the finality of an order denying stay relief without prejudice.”

In the case on appeal, Judge Tashima said that “the record makes clear that the [bankruptcy] court ‘unreservedly denied relief’” even though “the bankruptcy court stated that the denial was without prejudice.”

Judge Tashima gave several reasons for his conclusion about finality. Principally, the bankruptcy judge made it clear that the issues in the creditor’s proof of claim and adversary proceeding would be tried in bankruptcy court, not before a jury in state court. The bankruptcy court said it would hold trial in short order and gave no indication of an inclination to revisit stay relief.

In saying that stay denial was without prejudice, Judge Tashima said that the bankruptcy court meant that it was “willing to consider stay relief if sought for a different purpose, but not for the purpose of resolving [the creditor’s] state claims against [the debtor].”

The Merits of Stay Relief

In a separate but nonprecedential opinion, the panel dealt with the merits: Did the bankruptcy court abuse its discretion in denying stay relief? On the merits, the panel was divided. Oddly enough, Judge Tashima would have reversed and modified the stay.

The affirmance on the merits was an unsigned memorandum principally by the other two judges on the panel, Circuit Judges Milan D. Smith, Jr. and Paul J. Watford.

Generally, the two judges said, the appeals court would remand to the district court after reversing on appealability. In the case before them, they said that the record presented the issues, and the circuit court was in as good a position as the district court to address the merits.

The two judges saw no abuse of discretion and upheld denial of the stay-relief motion. Among other things, they said that the bankruptcy court “properly considered the interests of judicial economy.”

The Dissent

Judge Tashima agreed that the panel should reach the merits of stay relief. However, he “respectfully” dissented. He identified several reasons why the stay should have been modified.

State law issues predominated, he said. There would have been no basis for federal jurisdiction on many of the issues had there been no bankruptcy, and the creditor had a right to a jury trial.

Judge Tashima believed that denial of stay modification was an abuse of discretion.

The opinions are [*Harrington v. Mayer (In re Mayer)*](https://abi-opinions.s3.amazonaws.com/Mayer+Appealability.pdf), 20-56340 (9th Cir. March 8, 2022), and [*Harrington v. Mayer (In re Mayer)*](https://abi-opinions.s3.amazonaws.com/Mayer+Merits.pdf), 20-56340 (9th Cir. March 8, 2022).

#### To satisfy Article III, an appellee need only have ‘concrete adverseness’ and an ongoing interest in the dispute.

# Someone Defending an Appeal Isn’t Required to Show ‘Standing,’ Fifth Circuit Says

Even after a liquidating trust has expired by its terms, the Fifth Circuit tells us that the trustee retains the right to protect the trust estate and defend appeals.

The corporate chapter 11 debtor sold most of the assets and confirmed a plan. The plan created a liquidating trust to prosecute claims belonging to the estate. The confirmation order continued the automatic stay to protect assets of the trust.

The plan called for the trust to terminate at the end of 2018, about two years after the plan was confirmed.

Six months after the trust’s termination date, owners of the debtor sued third parties in bankruptcy court, asserting claims belonging to the estate. The owners reasoned that they could sue because the trust had terminated, and the trustee of the trust no longer had authority to prosecute claims of the estate.

The trustee of the liquidating trust sought sanctions in bankruptcy court and dismissal of the owners’ suit for interference with trust property. The bankruptcy court dismissed the owners’ suit and awarded sanctions representing the trustee’s legal expenses.

Later, the bankruptcy court ruled that the trustee continued in possession of trust property even though the trust had terminated.

The district court affirmed the dismissal and sanctions, and so did the Fifth Circuit in an opinion on February 11 by Circuit Judge Jerry E. Smith.

The owners argued in the circuit that the appeals court had no appellate jurisdiction because the trustee had no standing once the trust had terminated. The owners also wanted the circuit court to vacate the sanctions on the theory that the trustee had no standing to seek sanctions after the trust terminated.

Judge Smith observed that the bankruptcy judge had imposed sanctions under the court’s inherent power under Section 105(a) because the owners were interfering with trust property. He held that the bankruptcy court had jurisdiction to impose sanctions given that the bankruptcy court had jurisdiction over the debtor’s case.

Next, the owners argued that the trustee had no standing to defend the appeal. Judge Smith said that “standing isn’t the right doctrine.”

Citing the Supreme Court, Judge Smith explained that a litigant must have standing to “initiate” a proceeding. Because the trustee was defending the appeal, he said that the trustee “doesn’t need to show he would have standing.”

Again citing the Supreme Court, Judge Smith said that Article III only requires that the opposing party demonstrate “concrete adverseness” and have an ongoing interest in the dispute.

To conclude the analysis, Judge Smith referred to Texas law regarding the powers and responsibilities of a trustee after a trust has terminated. Although the trustee no longer had “legal ownership” of the trust assets, the trustee had continuing possession of the assets and a duty to return the trust property to the beneficiaries of the trust.

Consequently, Judge Smith said that the trustee had “an interest in defending his continued possession of the trust assets so he can fulfill his fiduciary duties and return the property to the trust beneficiaries. That’s enough to give him a meaningful interest in this case, so we have jurisdiction.”

Having established the circuit’s jurisdiction, Judge Smith proceeded to uphold the dismissal and sanctions on the merits.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Cleveland+Imaging.pdf) *Kreit v. Quinn (In re Cleveland Imaging & Surgical Hospital LLC)*, 21-20067 (5th Cir. Feb. 11, 2022).

#### Deciding to transfer venue, a North Carolina bankruptcy judge said that the debtor underwent a corporate restructuring ‘purely for the purpose of filing bankruptcy.’

# Johnson & Johnson Venue Transferred from North Carolina to New Jersey

Johnson & Johnson incorporated a newly formed subsidiary in North Carolina and filed a chapter 11 petition for that company in Charlotte two days later. According to Bankruptcy Judge J. Craig Whitley, J&J undertook the restructuring “to fully resolve talc-related claims through chapter 11 reorganization without subjecting the entire J&J enterprise to a bankruptcy proceeding.”

On motion by the bankruptcy administrator, Judge Whitley transferred venue to New Jersey, where J&J is headquartered and where 35,000 multidistrict talc cases have been pending against J&J for five years.

In his opinion on November 16, Judge Whitley said that J&J was “trying to manufacture venue and is attempting to outsmart the purpose of the [venue] statute.” Although he considered the “purposeful creation of venue,” Judge Whitley sent the case to New Jersey as the “more appropriate venue for the administration of the estate.”

The Facts

Just before filing, J&J created two new subsidiaries. One was to be the debtor. In substance, the other took over J&J’s businesses.

The debtor was first created in Texas as a limited liability company and converted to a North Carolina limited liability company. On October 14, two days later, the debtor filed a chapter 11 petition in Charlotte.

The debtor was given all talc-related claims and insurance receivables, plus $6 million cash in a North Carolina bank account. The debtor was also given an interest in a newly created affiliate. [Note: This analysis does not deal with fraudulent transfer or similar theories. The description of the corporate structure has been abbreviated to highlight factors of significance regarding venue.]

The debtor’s principal place of business is New Jersey, and its employees all work in New Jersey. The debtor has no operations in North Carolina, Judge Whitley said.

Of 38,000 talc-related tort suits against J&J, 35,000 have been in a multidistrict litigation in New Jersey district court for five years. Insurance companies are prosecuting declaratory judgment suits against J&J in a New Jersey state court pertaining to their obligations under insurance policies.

Given “the apparent lack of a connection to this judicial district as well as its own judicial resources,” Judge Whitley entered an order to show cause on October 25 to consider the bankruptcy administrator’s motion to transfer venue. Other parties then filed motions of their own to transfer venue to New Jersey or Delaware. At the hearing on November 10, the debtor opposed transferring venue. [Note: North Carolina is one of two states with bankruptcy administrators rather than U.S. Trustees.]

The Venue Statute

Under 28 U.S.C. §1408(1), venue is proper where the debtor has its “domicile, residence, principal place of business . . . or principal assets.” Judge Whitley said that venue was proper in North Carolina because the debtor was “a North Carolina entity on the filing date, if only for two days.”

Under 28 U.S.C. §1412, the court may transfer venue “in the interest of justice or for the convenience of the parties.”

Judge Whitley said that the debtor’s choice of venue is given “substantial weight” and that transferring venue is “highly unusual.” However, he said, “this case is highly unusual.” He spent the bulk of his opinion explaining why “the convenience of the parties and the interests of justice [both] warrant transfer of this case to the District of New Jersey.”

Convenience of the Parties

Regarding the convenience of the parties, Judge Whitley listed five factors and concluded that all counseled for venue transfer. There was substantial litigation in another district. At the request of J&J, the multidistrict panel had selected New Jersey as the venue for the 35,000-case multidistrict litigation. The multidistrict panel, he said, chose New Jersey “because it was convenient and accessible for all the parties involved.”

Although the multidistrict suit is currently stayed by Section 362, Judge Whitley said:

[I]t could even be joined with the bankruptcy case to help efficiently resolve thousands of talc related claims and aid in any future estimation proceeding. Therefore, the administration of this estate is best served by transferring this case to the District of New Jersey.

Other factors weighing in favor of transferring venue were: (1) the debtor’s headquarters in New Jersey; (2) the location of the debtor’s employees and witnesses in New Jersey; (3) the location of the parent’s headquarters in New Jersey; and (4) the lack of the debtor’s connections to North Carolina, aside from the $6 million bank account.

Judge Whitley distinguished two seemingly similar mass tort cases pending in North Carolina where the bankruptcy courts declined to change venue. In one, there was no other “inherently more favorable” venue, and in the second case, the venue motion was not decided until two years after filing.

Judge Whitley mentioned the three other mass-tort cases in his district but said there had been no motions to transfer venue.

The Interests of Justice

While the interests-of-justice standard is “broad and flexible,” Judge Whitley said that “forum shopping is also a consideration.”

Judge Whitley said that the debtor underwent a corporate restructuring “purely for the purpose of filing bankruptcy.” Quoting *In re Patriot Coal Corp.*, 482 B.R. 718, 745 (Bankr. S.D.N.Y. 2012), he said, “Setting up a company with the sole intent of filing bankruptcy in a certain district cannot be ‘the thing which the [venue] statute intended.’”

Judge Whitley said that the debtor was “attempting to outsmart the venue statute.” He cited the debtor for arguing that creditors wanted another venue “with a more friendly dismissal standard.”

Judge Whitley cited four other mass-tort cases where the debtors employed the so-called Texas Two Step and filed “for bankruptcy in this district shortly after its creation.” He said that “every debtor using the Texas Two Step filed for bankruptcy in this district. As a result, any superior experience and purported expertise this Court may possess as to divisional mergers exists only because it is the only court that has ever seen these issues.”

Judge Whitley saw “no reason this Court should be the only bankruptcy court to have the opportunity to weigh in on these novel legal issues, especially considering that the ‘Texas Two Step’ tactic is being employed by national corporations and impacts tens of thousands of present and future claimants across the country.”

Judge Whitley transferred venue to New Jersey, “potentially to be referenced to the Bankruptcy Court, should that Court deem it appropriate.”

Epilogue

The case has been transferred to the district of New Jersey, to be heard in Trenton before Chief Bankruptcy Judge Michael B. Kaplan. In New Jersey, the case number is 21-30589.

[The opinion is](https://abi-opinions.s3.amazonaws.com/LTL+Managemeny.pdf) *In re LTL Management LLC*, 21-30589 (Bankr. W.D.N.C. Nov. 16, 2021).

#### The Eleventh Circuit has subjected its trustees to the risk of expensive litigation in a faraway court unfamiliar with what happened in the bankruptcy case.

# Opinion Shows the Fault in Barring *Barton* Protection When a Case Is Closed

Now that the Eleventh Circuit has seemingly abolished the *Barton* doctrine as protection for estate professionals after bankruptcy cases have closed, an opinion by Bankruptcy Judge Erik P. Kimball shows how bankruptcy courts may no longer be available to protect trustees from the predation of possibly vexatious litigants.

As we shall discuss at the foot of this story, there still may be notions of jurisdiction that would allow the bankruptcy court to ride to the rescue.

The Obstreperous Debtor

The individual debtor filed a chapter 11 petition that was converted to chapter 7. In his January 28 opinion, Judge Kimball, from West Palm Beach, Fla., said that the case involved “an unusual amount of contentious litigation.”

Due a “great extent . . . to [the debtor’s] obstruction of the trustee and extreme litigiousness,” Judge Kimball said, the estate was insolvent; there was no distribution to unsecured creditors, and administrative creditors received “only a tiny portion of” their claims. He alluded to the debtor’s “shocking behavior.”

Judge Kimball said he had “twice held [the debtor] in contempt, including for previously filing suit against the trustee and trustee’s counsel without the Court’s authority during the pendency of his chapter 7 case.” He added that the debtor had been “permanently disbarred by the Florida Supreme Court, . . . [i]n part because of his actions in this case.”

More than one year after the chapter 7 case was closed, the debtor sued the chapter 7 trustee, the trustee’s counsel and others in federal district court in New York. Judge Kimball said that the lawsuit in New York was “a continuation of [the debtor’s] inappropriate actions in this Court, for which he was twice held in contempt.”

In addition to the trustee and the trustee’s counsel, defendants in the $30 million civil RICO suit included 13 law firms, seven lawyers and numerous individuals. The complaint raised a plethora of allegations of fraud in connection with legal proceedings involving the debtor.

The U.S. Trustee responded by filing a motion asking Judge Kimball to reopen the case and reappoint a chapter 7 trustee. Were he to reopen the case, Judge Kimball said, the U.S. Trustee would contend under the *Barton* doctrine that the debtor should have sought permission from the bankruptcy court before suing the chapter 7 trustee and his counsel.

The chapter 7 trustee joined in the motion by the U.S. Trustee.

The Doctrine and Its Limitations

The modern doctrine arose from *Barton v. Barbour*, 104 U.S. 126 (1881), where the Supreme Court held that receivers cannot be sued without permission from the appointing court. After adoption of the Bankruptcy Act of 1898, the doctrine was extended to cover bankruptcy trustees. *Barton* was subsequently broadened by many circuits to protect court-appointed officials and fiduciaries, such as trustees’ and debtors’ counsel, real estate brokers, accountants, and counsel for creditors’ committees.

Judge Kimball traced the adoption of the *Barton* doctrine in the Eleventh Circuit. First, the Eleventh Circuit held in 2000 that *Barton* protected trustees and other court-appointed officers for actions taken in their official capacity. In 2009, the Atlanta-based appeals court ruled that *Barton* protected a receiver’s court-approved counsel and other court-sanctioned professionals.

In both, Judge Kimball said that the underlying cases were still pending when *Barton* protection was invoked.

Then came *Tufts v. Hay*, 977 F.3d 1204 (11th Cir. Oct. 20, 2020), and *Chua v. Ekonomou*, 1 F.4th 948 (11th Cir. 2021), where the Eleventh Circuit created a split of circuits by holding that the *Barton* doctrine does not protect a bankruptcy trustee from suit after the bankruptcy case is closed and there are no more estate assets. To read ABI’s reports, [click here](https://www.abi.org/newsroom/daily-wire/eleventh-circuit-finds-discretion-to-disregard-the-barton-doctrine) and [here](https://www.abi.org/newsroom/daily-wire/barton-protection-ends-when-the-bankruptcy-case-closes-eleventh-circuit-says).

The New, Limited *Barton* Doctrine Applied

Judge Kimball said that *Chua* wrought “a significant change in Eleventh Circuit precedent.” After the 2021 decision, he said it is “not appropriate to apply the *Barton* doctrine primarily as a prophylactic measure to protect bankruptcy trustees and other representatives of the bankruptcy estate.”

After *Chua*, “the sole question,” Judge Kimball said, “is whether the bankruptcy court has subject matter jurisdiction over the matter presented in the suit. The *Barton* doctrine applies only where the suit would have a conceivable effect on the administration of the bankruptcy estate.”

Applying the facts to the law, Judge Kimball said that the estate was closed and fully administered. There were no longer any assets to distribute, so the lawsuit in New York “cannot impact distributions in this case as there are no longer any assets to distribute.”

Finding that “the *Barton* doctrine does not apply,” Judge Kimball denied the motion to reopen the case. He said there was no “subject matter jurisdiction over the claims brought against” the trustee and the trustee’s counsel.

As consolation for the trustee and his counsel, Judge Kimball said that judicial immunity still afforded “a remedy.”

Observations

By reopening the case, an estate would arise from the dead. Respectfully, jurisdiction in the bankruptcy court does not depend entirely on the existence of estate assets. Jurisdiction can exist if there is a conceivable effect on the estate.

Section 541(a) creates an estate alongside the filing of a petition. Nothing in the Bankruptcy Code requires the existence of assets in the U.S. before there is an estate or before a debtor can file a petition under title 11. In fact, Section 109(a) says that a person may be a debtor who has “a domicile, place of business, ***or*** property in the United States.” [Emphasis added.]

Although previously existing estate property may have disappeared, the ability of the chapter 7 trustee to sue the debtor for later misdeeds conceivably gave life to new estate assets that previously did not exist.

There would at least be a “conceivable” effect on the estate, given the right of the trustee to seek compensation for fending off the new lawsuit. The fact that the estate has no remaining cash assets would not obviate the right of the trustee to assert an administrative claim to be paid if assets were found to exist.

Given the debtor’s prior obstreperous behavior, it’s conceivable that the estate would have claims of some sort against the debtor, perhaps under Rule 11, for fomenting frivolous litigation or for violating prior bankruptcy court orders.

The trustee and counsel would have other defenses lending themselves to bankruptcy jurisdiction.

The trustee and his counsel received final allowances of compensation, which will bar claims by the debtor alleging misdeeds by the trustee and counsel. The final allowances arguably gave *res judicata* defenses available to the trustee and counsel that in turn may lead to sanctions against the debtor.

The bankruptcy court had discharged the trustee in closing the case, arguably absolving the trustee for misdeeds.

Although jurisdiction in the bankruptcy court would not be exclusive, the bankruptcy court arguably had concurrent jurisdiction to enforce and interpret its own prior orders.

All things considered, this writer respectfully submits there should be sufficient “related to” or “arising in” jurisdiction to permit the reopening of the case, to hear the defenses of the trustee and counsel, and to hear claims against anyone who may have offended the good order of the bankruptcy proceedings.

The trustee might have employed another strategy even if there were no bankruptcy jurisdiction.

The debtor brought suit in federal court in New York based on diversity jurisdiction. The trustee could have filed a venue motion, seeking to transfer the suit to a Florida district court.

Once in Florida, a district judge could refer the suit to the bankruptcy court as being “related to” the bankruptcy court. There would be no jurisdiction problem because the debtor was claiming diversity jurisdiction.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Keitel.pdf) *In re Keitel*, 15-21654 (Bankr. S.D. Fla. Jan. 28, 2022).

#### In a case that may be headed to the U.S. Supreme Court at least once more, the Fourth Circuit is subjecting 26 multinational oil companies to the tender mercies of the Maryland state courts.

# Texaco Plan in 1988 Wasn’t Grounds for Removal to Federal Court, Fourth Circuit Says

The Fourth Circuit employed colorful language in holding that the confirmation of the chapter 11 plan by Texaco Inc. 34 years ago provided no basis for removing an environmental lawsuit from state court to federal court.

The litigation has already been to the U.S. Supreme Court once and was back in the Fourth Circuit after remand. The plaintiff is the City of Baltimore, having brought suit in state court by asserting only state law claims against 26 multinational oil and gas companies.

The city alleged that the oil companies contributed to greenhouse gas pollution and deceived customers when they knew for almost 50 years about the link between fossil fuels and climate change. As Circuit Judge Henry F. Floyd said in his April 7 opinion for the Fourth Circuit, the city was seeking “to shift the costs of climate-change injuries onto” the oil companies.

The defendants removed the suit to federal district court based on eight theories of federal jurisdiction. Originally, the district court remanded the suit to state court, and the Fourth Circuit affirmed. The Supreme Court reversed and remanded, for reasons of little significance to bankruptcy nerds.

After remand, the district court remanded the suit a second time to state court, prompting the defendants’ second appeal to the Fourth Circuit.

Although the “impacts of climate change undoubt[ed]ly have local, national, and international ramifications,” Judge Floyd said, “those consequences do not necessarily confer jurisdiction upon federal courts *carte blanche*.”

Judge Floyd knocked down all of the asserted grounds for federal jurisdiction, principally because the city’s suit was based only on Maryland law and there is no governing federal common law. Among other things, he said that product liability has traditionally been in the realm of state law. He said that the oil companies “have failed to show that federal common law truly controls this dispute involving their fossil-fuel products and misinformation campaign.”

Judge Floyd also rejected the idea of federal jurisdiction based on the federal Clean Air Act and the concept of “federal officer removal” under 28 U.S.C. § 1442.

For ABI members, the opinion is noteworthy for its treatment of the bankruptcy removal statute, 28 U.S.C. § 1452(a). It allows a party to

remove any claim or cause of action in a civil action other than . . . a civil action brought by a governmental unit’s police or regulatory power, to the district court where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.

In turn, Section 1334(b) confers federal jurisdiction over civil proceedings arising under title 11 or arising in or related to a case under title 11.

Once a chapter 11 case has been confirmed, Judge Floyd said that the Fourth Circuit limits bankruptcy jurisdiction to disputes having a “close nexus” to the implementation, consummation, execution or administration of the plan.

For the defendants, the jurisdictional hook was the chapter 11 plan confirmed in 1988 by Texaco Inc., a subsidiary of one of the defendants.

“First,” Judge Floyd said, “we find it hard to fathom how Baltimore’s suit, filed thirty years later, has any ‘close nexus’ to Texaco’s confirmed plan because it is so far removed from the initial bankruptcy confirmation.”

“Secondly,” Judge Floyd said, “Baltimore’s claims are completely independent and distinct from Texaco’s bankruptcy plan, there is no indication that the bankruptcy plan involved climate change, and Defendants do not explain how a judgment more than thirty years later could impact Texaco’s estate.”

In short, Judge Floyd held that “Baltimore’s suit is too far removed from Texaco’s 1988 confirmed plan for us to find a ‘close nexus’ warranting bankruptcy jurisdiction.”

But Judge Floyd found a second ground for remand under Section 1452(a). It disallows the removal of a governmental unit’s enforcement of police or regulatory powers, and the defendants had sought to remove a suit exercising the city’s police or regulatory powers.

Baltimore indisputably is a governmental unit, and Judge Floyd had “no doubt this suit is a valid exercise of Baltimore’s police power” because the city was seeking “to protect its citizens, property, and resources by suing Defendants, all of whom are private parties, for the detrimental impacts of their fossil-fuel products.”

Naturally, Judge Floyd took “no view” on whether the city would prevail on its claims under state law. However, he affirmed the district court and said, “These claims do not belong in federal court.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Baltimore.pdf) *Mayor and City Council of Baltimore v. BP P.L.C.*, 19-1644 (4th Cir. April 7, 2022).

#### Two circuit have held this month that there is no ‘related to’ bankruptcy jurisdiction for climate-change lawsuits against energy companies.

# Another Circuit Says: Old Bankruptcies Aren’t Grounds for Removal to Federal Court

For a second time in 12 days, a circuit court has held that a chapter 11 plan confirmed by an energy company doesn’t permit multinational oil companies to remove a climate-change lawsuit to federal court.

Like the Fourth Circuit’s decision on April 7 in *Mayor and City Council of Baltimore v. BP P.L.C.*, 19-1644, 2022 BL 121937, 2022 US App Lexis 9409 (4th Cir. April 7, 2022), the Ninth Circuit ruled on April 19 that a confirmed chapter 11 plan did not bear a “close nexus” to a climate-change lawsuit. To read ABI’s report on *Baltimore*, [click here](https://www.abi.org/newsroom/daily-wire/texaco%E2%80%99s-plan-in-1988-wasn%E2%80%99t-grounds-for-removal-to-federal-court-fourth-circuit).

The facts and the procedural posture in the Fourth and Ninth Circuits were similar. In 2017, six California cities and counties sued dozens of oil and gas companies in California state court, asserting only state-law claims. The plaintiffs alleged that the energy companies wrongfully promoted fossil fuels and concealed their known hazards. The plaintiffs are seeking damages for the costs to be thrust on municipalities as a result of climate warming and rising sea levels.

The energy companies removed the suit to federal court, asserting there was federal jurisdiction on six grounds, including federal question, federal enclave, federal officer removal, and bankruptcy jurisdiction. The district court rejected all assertions of federal subject matter jurisdiction. The district court stayed its remand order pending appeal to the Ninth Circuit.

In 2020, the Ninth Circuit affirmed the district court’s ruling regarding the federal officer removal statute. The appeals court dismissed the remainder of the appeal for lack of appellate jurisdiction.

Meanwhile, the energies companies appealed *Baltimore* to the Supreme Court, where the high court reversed and held that 28 U.S.C. § 1447(d) permitted appellate review of all of the defendants’ asserted grounds for removal. In the California case, the Supreme Court reversed and remanded for consideration in light of *Baltimore*.

So, the question of remand was back in the Ninth Circuit’s lap to consider whether remand was proper despite all of the defendants’ theories about federal jurisdiction.

In her April 19 opinion, Circuit Judge Sandra S. Ikuta affirmed the district court’s remand. Because our readers are bankruptcy nerds, we will only discuss her opinion regarding the bankruptcy removal statute, 28 U.S.C. § 1452(a). It allows a party to

remove any claim or cause of action in a civil action other than . . . a civil action brought by a governmental unit’s police or regulatory power, to the district court where such civil action is pending, if such district court has jurisdiction of such claim or cause of action under section 1334 of this title.

In turn, Section 1334(b) confers federal jurisdiction over civil proceedings arising under title 11 or arising in or related to a case under title 11.

The energy companies based removal on the chapter 11 plan of Texaco Inc., which was confirmed in 1988, and the plan confirmed in 2017 by Peabody Energy Corp., a coal company.

In deciding whether a lawsuit is “related to” a bankruptcy, Judge Ikuta said that the Ninth Circuit has “differentiated between bankruptcy cases that are pending before a plan has been confirmed and bankruptcy cases where the plan has been confirmed and the debtor discharged from bankruptcy.”

Consequently, Judge Ikuta said, “the same term ‘related to’ has a more limited meaning after a plan has been confirmed.” When a lawsuit arises after confirmation, she said there is “related to” bankruptcy jurisdiction “only if there is ‘a close nexus to the bankruptcy plan or proceeding.’”

In turn, Judge Ikuta said there is a close nexus if the new case involves the interpretation, implementation, consummation, execution or administration of the confirmed plan.

The energy companies argued there was a close nexus to the Peabody bankruptcy because the confirmed plan would have discharged the municipalities’ claims in California. In fact, by the time the district had ruled on the remand motion, the Peabody bankruptcy court had directed the plaintiffs to dismiss the suit against Peabody.

Where “the district court’s review of a plan involves merely the application of the plan’s plain or undisputed language, and does not require any resolution of disputes over the meaning of the plan’s terms,” Judge Ikuta said that “the review does not ‘depend upon resolution of a substantial question of bankruptcy law.’”

Judge Ikuta said that the energy defendants did not contend that the district court would be interpreting “disputed language” in the Peabody plan. “Accordingly,” she said, “the complaints before the district court were not ‘related to’ Peabody Energy’s bankruptcy case for purposes of § 1334(b), and the district court did not have removal jurisdiction over the complaints under § 1452 on that basis.”

The energy’s company reliance on the Texaco bankruptcy met the same fate. The energy companies did not argue that the district court would be interpreting “disputed language” in the Texaco plan, Judge Ikuta said.

“Moreover,” Judge Ikuta said, Texaco’s relationship to the California lawsuit was “attenuated” because Texaco was not named as a defendant. The district court, she said, would not “look at” the Texaco plan unless Texaco was held to be “a proper defendant” and the court decided that the municipalities claim arose before Texaco’s confirmation in 1988.

Seeing no “close nexus” to the Texaco plan, Judge Ikuta saw no bankruptcy removal jurisdiction under Section 1452.

[The opinion is](https://abiworld.box.com/s/rlgp5i4p1cm92rolk3axpepk13kgo4fe) *County of San Mateo v. Chevron Corp.*, 18-15499 (9th Cir. April 19, 2022).

#### Someone seeking to issue a subpoena to a trustee is the proper party to seek leave under the Barton doctrine, Judge Clarkson says.

# California Judge Splits with his BAP; Subpoenas Require Court Approval Under *Barton*

Someone issuing a subpoena to a bankruptcy trustee in a criminal case or a lawsuit outside of bankruptcy court must first ask the bankruptcy court for permission to issue the subpoena in view of the *Barton* doctrine, for reasons explained by Bankruptcy Judge Scott C. Clarkson of Santa Ana, Calif.

Without prior bankruptcy court approval, expenses incurred by a trustee to comply with a subpoena issued outside of bankruptcy court would be an unauthorized use of estate property not in the ordinary course of business under Section 363(b), Judge Clarkson said in his March 3 opinion. The opinion suggests that a third party intending to issue a subpoena to a bankruptcy trustee for a case outside of bankruptcy court should offer to reimburse the estate for the expense of complying with the subpoena.

The Criminal Subpoena

The case involved Michael Avenatti, whose law firm is in chapter 7 liquidation in Judge Clarkson’s court. Individually, Mr. Avenatti is a defendant in a criminal case in California, with a trial scheduled to begin on May 10. He is now appealing a criminal judgment entered against him in February in New York.

Mr. Avenatti went to trial in a separate criminal case in New York beginning on January 24. The jury found him guilty of wire fraud and aggravated identity theft in a verdict on February 4.

In the criminal case that went to trial in January, both the prosecution and the defense had issued subpoenas on the California trustee demanding that the trustee appear personally and produce four terabytes of data held by the trustee.

On January 24, when the trial was beginning in New York, the California trustee filed an emergency motion asking Judge Clarkson to authorize expenses to be incurred in complying with the two subpoenas. The motion did not challenge the validity of the subpoenas, although the trustee’s motion did mention the *Barton* doctrine.

The doctrine arose from *Barton v. Barbour*, 104 U.S. 126 (1881), where the Supreme Court held that receivers cannot be sued without permission from the appointing court. After adoption of the Bankruptcy Act of 1898, the doctrine was extended to cover bankruptcy trustees. *Barton* was subsequently broadened by many circuits to protect court-appointed officials and fiduciaries, such as trustees’ and debtors’ counsel, real estate brokers, accountants, and counsel for creditors’ committees.

*Barton* Applied

Although the trustee was not asking for a declaration that the subpoenas were invalid under *Barton*, Judge Clarkson said that “the Court must address issues that pertain to the Motion’s essence; namely, those principles that make up the *Barton* Doctrine.”

Judge Clarkson said that *Barton* was based on the notion that the bankruptcy court has exclusive jurisdiction of the estate. As the Ninth Circuit held in 2005, a party must first obtain leave from the bankruptcy court before “it initiates an action in another forum against a bankruptcy trustee or other officer appointed by the bankruptcy court for acts done in the officer’s official capacity.”

*In re Crown Vantage, Inc.*, 421 F.3d 963, 970 (9th Cir. 2005).

Judge Clarkson relied heavily on *In re Circuit City Stores, Inc.*, 557 B.R. 443 (Bankr. E.D. Va. 2016), where the bankruptcy court applied *Barton* to subpoenas served on trustees or other officers or their agents “owing their positions to bankruptcy court orders.”

On the other side of the fence, Judge Clarkson cited *In re Media Group, Inc.*, 2006 WL 6810963 (B.A.P. 9th Cir. 2006), where he said that the BAP “declined to extend the application of the *Barton* Doctrine to a subpoena issued on a trustee’s lawyer.”

Judge Clarkson described the BAP as believing that *Barton* only applies to lawsuits against trustees, not subpoenas.

As an opinion from the BAP, even in his own circuit, Judge Clarkson said that *Media Group* was “not binding precedent.” He also said that the BAP “did not correctly apply the rule of law developed either in the Supreme Court’s 1881 decision in *Barton* or the Ninth Circuit’s 2005 *Crown Vantage* decision.” In his opinion, the BAP “engaged in a too narrow, textual analysis of the Supreme Court’s decision in *Barton*.”

Judge Clarkson quoted *Crown Vantage* for applying *Barton* to “all legal proceedings.” Under “any common-sense interpretation,” commanding a trustee to appear 3,000 miles away “involves a legal proceeding,” he said.

Although the Ninth Circuit has not addressed the question, Judge Clarkson said that he was “persuaded that the application of the *Barton* Doctrine respecting subpoenas, as so thoughtfully discussed in the more recent (2016) *Circuit City* case*,* is appropriate.”

Without permission from the bankruptcy court, Judge Clarkson said that the trustee could not comply with the subpoena because the trustee would have been using estate property outside of the ordinary course of business in violation of Section 363(b).

By asking him for permission to comply with the subpoena, Judge Clarkson said that the trustee was seeking permission to use estate property “without first allowing this Court to engage in a *Barton* analysis . . . . This was improper.”

“The proponent[s] of the subpoenas are the proper parties to seek permission to submit these subpoenas,” Judge Clarkson said. “In the absence of this Court’s prior approval, the subpoenas commanding the Trustee to use Estate resources usurp the power and authority of this Court.”

Judge Clarkson denied the trustee’s motion with prejudice, saying that *Barton* “considerations should be raised in the first instance by the issuers of the proposed subpoenas.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Avenatti.pdf) *In re Egan Avenatti LLP*, 19-13560 (Bankr. C.D. Cal. March 3, 2022).

### Plans & Confirmation

#### Manhattan district judge vacated confirmation of Purdue Pharma’s chapter 11 plan because the court had no statutory power to impose non-consensual releases of creditors’ direct claims against non-debtors.

# Third-Party, Non-Consensual Releases Nixed in the Purdue ‘Opioid’ Reorganization

Non-consensual releases of creditors’ direct claims against non-debtors are not permitted by the Bankruptcy Code, according to District Judge Colleen McMahon of Manhattan, who vacated the bankruptcy court’s confirmation of the controversial Purdue Pharma LP chapter 11 plan.

Had the reorganization plan been upheld (or if it is upheld after appeal to the Second Circuit), the controlling Sackler family’s $4.325 billion contribution to the reorganization plan would have absolved them from all liability stemming from the opioid crisis, even if creditors with direct claims did not consent.

Judge McMahon’s 142-page decision on December 16 is perhaps the most outstanding and remarkable bankruptcy opinion of the decade. Unless reversed on appeal, she will have barred debtors from confirming chapter 11 plans in the Second Circuit with non-consensual releases of creditors’ direct claims against non-debtor third parties.

Prof. Ralph Brubaker agrees. He told ABI:

This is one of the most consequential decisions for the chapter 11 system that’s ever been handed down. Judge McMahon’s decision goes even further than the previous decisions of the Fifth, Ninth, and Tenth Circuits prohibiting nonconsensual non-debtor releases. Judge McMahon has forcefully declared that bankruptcy judges have no inherent common-law discharge power. That power resides exclusively with Congress, and outside of asbestos cases, nothing in the Bankruptcy Code authorizes bankruptcy judges to discharge the obligations of a nondebtor.”

Prof. Brubaker is the James H.M. Sprayregen Professor of Law at the University of Illinois College of Law.

The Decision Is Limited

Contrary to what may have been reported in the press, Judge McMahon did not prohibit all non-debtor releases, nor did she bar members of the Sackler family from obtaining releases from perhaps the majority of opioid claims.

Judge McMahon’s opinion is narrow. She only barred non-consensual releases where creditors have direct claims against the Sacklers that are not derivative of claims that the company has against family members.

Judge McMahon’s opinion is consistent with the Second Circuit’s approval of more limited releases given to non-debtors in the liquidation of the Bernard Madoff Ponzi scheme. There, the Manhattan-based appeals court ratified non-consensual releases given to non-debtor defendants who knew that Bernard Madoff was conducting a Ponzi scheme and who made settlements with the trustee on the understanding that they could not be sued by Madoff’s defrauded customers. The releases only applied when defrauded customers were suing on the same claims held by the Madoff trustee.

U.S. Attorney General Merrick B. Garland applauded the opinion. Immediately after it came down, he issued a statement saying that the “bankruptcy court did not have the authority to deprive victims of the opioid crisis of their right to sue the Sackler family.” The statement is an overbroad characterization of the opinion, but it signals that the government is on the side of limiting third-party releases in bankruptcy cases if the case eventually goes to the Supreme Court.

The opinion has ominous implications for other mass-tort bankruptcies, like the Boy Scouts’ chapter 11 case in Delaware. Judge McMahon’s opinion is not binding on the bankruptcy judge in Delaware. However, the plan proposed by the Boy Scouts would bar thousands of claims by allegedly abused men who have direct claims against scout leaders and organizations not in bankruptcy. It remains to be seen if the Delaware courts follows the *Purdue* decision from New York.

The Executive Summary

Judge McMahon in substance wrote an executive summary about her legal conclusions on pages 6 and 7 of her typescript opinion. She said that the bankruptcy court had subject matter jurisdiction to enter non-consensual releases, even though the bankruptcy court “may have lacked constitutional authority” to give final approval.

The “great unsettled question,” Judge McMahon said, is whether “any court . . . is statutorily authorized to grant such releases.” The circuits are split, but the Second Circuit “has not yet analyzed the issue,” despite having “identified the question” in 2005.

“This will no longer do,” Judge McMahon said. “Either statutory authority exists or it does not. . . . Moreover, the lower courts are desperately in need of an answer.”

In her summary, Judge McMahon summed up her holding:

[T]he Bankruptcy Code does not authorize such non-consensual non-debtor releases; not in its express text (which is conceded); not in its silence (which is disputed); and not in any section or sections of the Bankruptcy Code that, read singly or together, purport to confer generalized or “residual” powers on a court sitting in bankruptcy.

Judge McMahon found it unnecessary to reach constitutional questions. Likewise, she did not decide whether the settlement with the Sacklers was permissible if the Second Circuit were to decide that she was wrong about releases.

“This is a real ‘the emperor has no clothes’ moment for the chapter 11 system,” Prof. Brubaker told ABI. He added:

The legal legitimacy of nonconsensual non-debtor releases has always been dubious, at best. The parties, though, have engaged bankruptcy and appellate judges in an ultra-high-stakes game of chicken, daring them to blow up complex deals they have spent years and many millions (and in the *Purdue* case, hundreds of millions) of dollars negotiating. Judge McMahon is pressing the Second Circuit (and perhaps ultimately the Supreme Court) to put an end to that practice by definitively resolving the legal permissibility of nonconsensual non-debtor releases, once and for all.

The Facts

In minute detail, Judge McMahon laid out the facts and procedural history in the first 70 pages of her opinion, allowing the Second Circuit to focus on the law in the inevitable next appeal.

Purdue is a privately-held company owned by members of the Sackler family and controlled by them until not long before bankruptcy. Between 1996 and 2019, Purdue had revenue of $34 billion, with 91% emanating from the company’s opioid called OxyContin.

Judge McMahon explained how Purdue pled guilty to one felony count in 2007 for falsely marketing the opioid. Four company officers pled guilty to misdemeanor charges of misbranding. The company paid $600 million in fines.

After the plea, Judge McMahon said that the company’s profits “were driven almost exclusively” by aggressively marketing the opioid.

By 2014, lawsuits were mounting, and Sackler family members were being named as defendants. Discovery led to allegations that some of the Sacklers set sales targets for the opioid that were higher than those recommended by company executives.

Citing the bankruptcy judge’s findings, Judge McMahon said that the Sacklers “distributed significant sums of Purdue money to themselves” from 2008 to 2016, when they were “aware of the opioid crisis and the litigation risk.”

The distributions from 2008 to 2016 were a “sharp departure” from the practice in 1996 to 2007. In the prior years, the distributions to the family amounted to about 9% of company revenue, enough to cover taxes. In the later years, the distributions were an average of 53% of revenue, Judge McMahon said.

The distributions in the later years aggregated about $10.4 billion. Of the total, some $4.6 billion paid pass-through taxes. The family’s own expert said that the withdrawals substantially reduced the company’s “solvency cushion.”

Judge McMahon cited the bankruptcy judge for saying that the distributions would allow the company to assert more than $11 billion in avoidable transfers.

Facing a “veritable tsunami of litigation,” the company filed a chapter 11 petition in September 2019. Immediately, the bankruptcy court approved a temporary injunction barring suits against the Sackler family, their trusts and other officers, directors or employees.

The injunction stopped more than 2,900 suits against the company and 400 against the Sacklers. Upheld in district court, the injunction was extended 18 times, until plan confirmation this year.

In the chapter 11 case, 614,000 creditors filed claims asserting damages for more than the world’s domestic product, Judge McMahon said. Nonetheless, the so-called bar date occurred before potential creditors with direct claims against the Sacklers were to learn that that the plan would extinguish their claims.

The company took another plea in 2020 while in bankruptcy, conceding extensive violations of the 2007 plea agreement. Judge McMahon said the violations “began almost from the time the ink was dry” on the 2007 plea deal.

The Chapter 11 Plan

With the help of mediators, the Sacklers agreed to contribute $4.325 billion toward Purdue’s chapter 11 plan, on the condition that their payments over nine years would end lawsuits against the family for all time.

Demanded by the bankruptcy judge, Purdue amended its plan to provide that the non-consensual releases in favor of the Sacklers barring future litigation would apply only where the company’s conduct was “a legal cause or a legally relevant factor to the cause of action against” a family member.

Judge McMahon said that the non-consensual releases in the plan in favor of the Sacklers would cover “[a]ll present and potential claims connected with OxyContin and other opioids.” She said that the releases included “third-party claims that could not be asserted by the Debtors against” the Sacklers “but were particularized to others.”

“Chief among those claims,” Judge McMahon said, “are claims asserted by the states — both consenting states and the objecting states — arising under various unfair trade practices and consumer protection laws that make officers, directors and managers who are responsible for corporate misconduct personally liable for their actions.”

Judge McMahon characterized the plan as providing “broad releases” to members of the Sackler family, “not just of derivative, but of particularized or direct claims.”

The U.S. Trustee, eight states and others objected to confirmation. The U.S. Attorney from New York filed a statement of interest supporting objections to the breadth of the releases.

Summarizing the bankruptcy judge’s confirmation opinion in detail, Judge McMahon called it “a judicial *tour de force*.” The bankruptcy judge found no other reasonably conceivable means to achieve the result reached by the plan and said that failure to confirm the plan would lead to Purdue’s liquidation and no recovery for unsecured creditors, including personal injury plaintiffs.

The bankruptcy judge confirmed the plan on September 17, 2021, “with obvious reluctance,” Judge McMahon said. The plan had been approved overwhelming by creditors.

The U.S. Trustee, eight states, the District of Columbia, several cities in Canada, several Native American tribes and a number of *pro se* creditors filed appeals from the confirmation order. The U.S. Attorney in New York filed an *amicus* brief supporting the appellants.

To preclude invocation of equitable mootness, Judge McMahon accelerated the appeal and issued her decision on December 16, before the plan was due to be consummated.

*Stern v. Marshall*

On the merits, Judge McMahon first addressed the standard of review and the implications of *Stern v. Marshall*, 564 U.S. 462 (2011). She said that the bankruptcy judge “improperly elided” his authority to confirm the plan, “an indubitably core function,” with authority to dispose of claims finally where the bankruptcy court only had “related to” jurisdiction.

Judge McMahon disagreed with a recent Third Circuit opinion where the Philadelphia-based appeals court read *Stern* as allowing the bankruptcy court to confirm a plan with similar releases because the injunctions were “integral” to restructuring the debtor-creditor relationship. *See* *Millennium Lab Holdings LLC*, 945 F.3d 126 (3d Cir. 2019), *cert. den.* 140 S.Ct. 2805 (2020). To read ABI’s report on *Millennium*, [click here](https://abi-opinions.s3.amazonaws.com/Millennium.pdf).

Applying *Stern*, Judge McMahon said that the proper analysis requires deciding whether the releases “would necessarily be resolved in the claims allowance process — not whether the release and injunction are ‘integral to the restructuring of the debtor-creditor relationship.’” She said that the debtor “cannot manufacture constitutional authority to resolve a non-core claim by the artifice of including a release of that claim in a plan of reorganization.”

Because the nonconsensual releases were “the equivalent of a final judgment for *Stern* purposes,” Judge McMahon held that the bankruptcy judge did not have power to enter a final order and “should have tendered” proposed findings and conclusions of law.

Prof. Brubaker agrees that *Stern* does not allow the bankruptcy court to enter a final confirmation order with releases of the sort. *See* Ralph Brubaker, *A Case Study in Federal Bankruptcy Jurisdiction: Core Jurisdiction (or Not) to Approve Non-Debtor ‘Releases’ and Permanent Injunctions in Chapter 11*, 38 Bankr. L. Letter No. 2, at 7-8 (Feb. 2018). To read, [click here](https://abi-opinions.s3.amazonaws.com/Brubaker+on+Stern.pdf).

N.B.: Should Judge McMahon’s analysis be adopted universally, equitable mootness will not be an issue in cases where the district judge alone can enter a final order of confirmation. To the argument that the delay resulting from district court review would be the death of chapter 11 cases, the answer is this: The district and bankruptcy judges could sit together at the confirmation hearing.

Subject Matter Jurisdiction

Objectors argued that the bankruptcy court lacked subject matter jurisdiction to underpin releases. Judge McMahon recognized that third parties’ claims against non-debtors “touches the outer limits of the Bankruptcy Court’s jurisdiction.”

In the Second Circuit, Judge McMahon said there is subject matter jurisdiction if the outcome might have “any conceivable effect” on the estate.

Judge McMahon said there was “absolutely no question” about the existence of subject matter jurisdiction under the rubric of “related to” because the releases might have a conceivable effect on the estate.

Statutory Authority for Non-Debtor Releases

Throughout, when we refer to releases, we mean non-consensual releases of creditors’ direct claims against non-debtors. Releases will not refer to derivative claims, which Judge McMahon defined as meaning claims that would make the Sacklers liable based on the company’s actions.

Releases refers to injunctions barring claims based on non-debtors’ own conduct, “predicated on their own alleged misconduct and the breach of duties owed to claimants other than Purdue,” Judge McMahon said.

Judge McMahon did not leave the reader in suspense for long. She quickly said that the Bankruptcy Code “does not confer on any court the power to approve the release of non-derivative third-party claims against non-debtors, including specifically” some of the releases in the Purdue plan.

The Primacy of Section 524(g)

Judge McMahon found only one provision in the Bankruptcy Code, Section 524(g), which authorizes injunctions barring third-party claims, and then “exclusively in cases involving . . . injuries arising from the . . . sale of asbestos.” In confirming the Johns-Manville plan years ago, she noted that the Second Circuit “did not cite to a single section of the Bankruptcy Code as authorizing the entry of the injunction.” *See MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89 (2d Cir. 1988).

After *Manville*, Congress adopted Section 524(g), codifying the result in *Manville* for asbestos cases. Judge McMahon interpreted the statute to mean that Congress retained “the task of determining whether and how to extend a rule permitting non-debtor releases . . . into other areas.”

In other words, Judge McMahon believes that *Manville* was not binding on her and did not compel her to approve the Purdue plan because the decision was overruled *sub silentio* when Congress later adopted Section 524(g).

The Split Among the Circuits

Judge McMahon surveyed the circuits, where she found “a long-standing conflict among the Circuits” and no “definitive guidance” from the Second Circuit. After *Manville*, she said in substance that no Second Circuit decision had actually approved non-debtor releases. She cited *Madoff* for the notion that Section 105(a) supplied power to enjoin derivative claims. *See In re Bernard L. Madoff Inv. Securities LLC*, 740 F.3d 81 (2d Cir. 2014).

Summarizing, Judge McMahon said that Second Circuit law is “unsettled, except in asbestos cases where statutory authority is clear. . . . [I]ts only clear statement is that Section 105(a), standing alone, does not confer such authority . . . outside the asbestos context.”

The other circuits are in conflict, Judge McMahon said. The Fifth, Ninth and Tenth Circuits “reject entirely the notion that a court can authorize non-debtor releases outside the asbestos context.”

In approving releases of the type, Judge McMahon said that the Third Circuit “has not identified any section of the Bankruptcy Code that authorizes such non-debtor releases.” The Fourth and Eleventh Circuit “have concluded that Section 105(a), without more, authorizes such releases.”

Judge McMahon read the Sixth and Seventh Circuits as holding that Sections 105(a) and 1123(b)(6), “read together, codify something that they call a bankruptcy court’s ‘residual authority’” to impose releases.

The Purdue bankruptcy judge found statutory authority from a combination of Sections 105(a), 1123(a)(5), (b)(6) and 1129. Judge McMahon said that those sections only confer power “to enter orders that carry out other, substantive provisions of the Bankruptcy Code.” Since the Code nowhere authorizes releases of the type, she held that none of them conferred the necessary statutory power.

Judge McMahon noted that some of the governments’ claims for civil penalties would not be dischargeable even if the individuals were to file their own bankruptcies.

The Debtor’s Other Arguments

The debtor argued that the absence of a statutory prohibition permitted the releases.

Judge McMahon said that Congress has not been silent. It “has in fact spoken” in “Sections 524(g) and (h) to preempt the field where non-debtor releases are concerned. . . . Congress in its wisdom elected to limit Code-based [releases] to asbestos litigation.”

Finally, Judge McMahon found no “residual authority.” If residual power were to exist, it would be “exercised in contravention of specific provisions of the Bankruptcy Code.” She declined “to insert a right that does not appear in the Bankruptcy Code to achieve a bankruptcy objective.”

Because “the Bankruptcy Code confers no such authority” to grant releases, Judge McMahon ruled that “the order confirming the Plan must be vacated.”

Scholarly Commentary

Prof. Brubaker identifies a path for reaching the same result without stretching a bankruptcy court’s statutory powers beyond the breaking point. In a forthcoming article in the *Yale Law Journal Forum*, he says that “efficient (and fair) joint settlements of both debtors’ and nondebtors’ mass tort liability will still be possible, even (and particularly) if nonconsensual nondebtor releases are prohibited.” Ralph Brubaker, *Mandatory Aggregation of Mass Tort Litigation in Bankruptcy*, 131 Yale L.J.F. (forthcoming 2022).

He goes on to say that the “essential architecture for facilitating powerful aggregation and corresponding settlement of tort victims’ claims against nondebtors already exists in the bankruptcy jurisdiction, removal, and venue provisions of” 28 U.S.C. § 157(b)(5). The section, he said, “provides for single-district consolidation of all creditors’ related personal injury claims against a nondebtor, in a manner similar to an MDL consolidation. . . . In fact, section 157(b)(5) consolidations would be an immensely more powerful and fairer centralization process than MDL consolidations.”

To read the forthcoming article, [click here](https://abi-opinions.s3.amazonaws.com/Brubaker+future+article.pdf).

[The opinion is](https://abi-opinions.s3.amazonaws.com/Perdue+by+McMahon.pdf) *In re Purdue Pharma LP*, 21-07532 (S.D.N.Y. Dec. 16, 2021).

#### A district judge in Virginia holds that third-party, non-debtor releases must be approved by district judge under Stern and must comply with the strictures of Federal Rule 23.

# Another District Judge Emphatically Rejects a Plan with Non-Debtor Third-Party Releases

In a scorching opinion, a district judge in Richmond, Va., set aside confirmation of a chapter 11 plan that contained “extremely broad third-party (non-debtor) releases.”

District Judge David J. Novak said that the releases in the appeal before him “represent the worst of this all-too-common practice, as they have no bounds.” He described the releases as barring the claims

of *at least* hundreds of thousands of potential plaintiffs not involved in the bankruptcy . . . , shielding an incalculable number of individuals associated with the Debtors . . . for an unspecified time period stretching back to time immemorial . . . .” [Emphasis in original.]

Judge Novak said that the bankruptcy court “exceeded the constitutional limits of its authority . . . , ignored the mandates of the Fourth Circuit . . . , and offended the most fundamental precepts of due process.”

Referring to what he called the “ubiquity of third-party releases” approved by a bankruptcy judge in Richmond who “regularly approves third-party releases,” Judge Novak said that “[t]his recurrent practice contributes to major companies like [the debtor] using the permissive venue provisions of the Bankruptcy Code to file for bankruptcy here.”

Citing the U.S. Trustee, Judge Novak said that “the Richmond Division (just the division, not the entire Eastern District of Virginia) joins the District of Delaware, the Southern District of New York, and the Houston Division of the Southern District of Texas as the venue choice for 91% of the ‘mega’ bankruptcy cases.”

On the penultimate page of his 88-page opinion reversing and remanding, Judge Novak directed the chief bankruptcy judge to reassign the chapter 11 case to another bankruptcy judge outside of the Richmond division. If there is another appeal after remand, Judge Novak said that the new appeal would be assigned to him.

Takeaways

On December 16, District Judge Colleen McMahon in New York vacated confirmation of the Purdue Pharma LLP chapter 11 plan, holding that the court had no statutory power to impose non-consensual releases of creditors’ direct claims against non-debtor third parties. *In re Purdue Pharma LP*, 21-07532, 2021 BL 482465, 2021 WL 5979108 (S.D.N.Y. Dec. 16, 2021). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/third-party-non-consensual-releases-nixed-in-the-purdue-%E2%80%98opioid%E2%80%99-reorganization).

The January 13 opinion by Judge Novak goes beyond Judge McMahon’s more narrow preservation of creditors’ direct claims against non-debtors. Readers may draw some of the following conclusions from Judge Novak’s opinion.

* Third-party releases are virtually impermissible when the releasing parties are receiving no consideration under the chapter 11 plan and the creditors do not manifest actual consent, under high standards for what constitutes actual consent.
* Just providing creditors with an ability to opt out does not make the release consensual as a matter of fact and law.
* The limited power of a bankruptcy judge under Article I of the Constitution requires that third-party releases be approved by district judges, and confirmation orders with third-party releases should be reports and recommendations.
* The procedure for approval of third-party releases in a chapter 11 plan must comply with Federal Rule 23, which deals with class actions. Among other things, creditors who are losing the right to sue must be involved in negotiations on the plan and must be adequately represented.
* Like the Eighth Circuit, which limited the doctrine of equitable mootness almost to the vanishing point, equitable mootness will not protect third-party releases from appellate review.
* A creditor who opts out has no standing to appeal.

Judge Novak’s opinion is required reading for anyone involved in chapter 11 practice. He gathers together authorities that are either hostile to or limit third-party releases.

However, Judge Novak does not proscribe third-party releases altogether. Indeed, he could not in view of *Behrmann v. Natl. Heritage Found. Inc.*, 663 F.3d 704 (4th Cir. 2011), where the Fourth Circuit adopted the Sixth Circuit’s approach to approval of third-party releases and rejected the idea that Section 524(e) bars them outright.

The Facts

The debtors were Mahwah Bergen Retail Group, Inc. and affiliates. Together, they operated 2,800 retail stores with names like Ann Taylor, LOFT and Lane Bryant. The debtors had about $1.6 billion in secured debt and perhaps $800 million in unsecured debt.

In chapter 11, they sold the business in three sales for more than $650 million. The chapter 11 plan paid some secured creditors and set aside $7.25 million in cash for unsecured creditors.

Before bankruptcy, plaintiffs filed a securities class action suit in New Jersey against the debtors and several individuals, including the debtors’ former chief executive and former chief financial officer. The district court had not certified the class before the chapter 11 filing brought the suit to a halt.

As confirmed by the bankruptcy court, the plan included “extremely broad” releases that “cover any type of claim that existed or could have been brought against anyone associated with the Debtors as of the effective date of the plan,” Judge Novak said.

At the confirmation hearing, Judge Novak said that the bankruptcy court focused on the claims that would be released against the former CEO and CFO in the class action. The bankruptcy court, he said, “ignored all of the other potential claims (both federal and state claims) released against others covered by the releases.”

The plan allowed creditors and shareholders to opt out of the releases. Shareholders were not receiving any consideration under the plan, although they would be released from any claims that the debtors might hold against those who did not opt out.

The debtors sent notices and opt-out forms to some 300,000 parties believed to be in the putative class. Almost 600 opted out, representing 0.2% of the class. Notice was published in two newspapers with nationwide publication.

Other than shareholders, the bankruptcy court did not require that notice and opt-out forms be sent to anyone else who would be giving releases, including employees, consultants, accountants, attorneys for the debtors or any of their affiliates, lenders, owners or shareholders.

The named plaintiffs in the class action opted out for themselves and attempted to opt out for the class. The bankruptcy court declined to allow the plaintiffs to opt out for the class.

The plan also contained exculpation clauses in favor of the debtors, the creditors’ committee, committee members, shareholders who did not opt out, the term loan agent and anyone related to them.

The class plaintiffs and the U.S. Trustee unsuccessfully objected to confirmation and filed appeals. They also unsuccessfully sought stays pending appeal from both the bankruptcy court and the district court.

Standing to Appeal

The debtors agreed that the U.S. Trustee had standing to appeal but challenged the appellate standing of the class plaintiffs.

Citing the Second Circuit and other appellate authority, Judge Novak said that the class plaintiffs could not establish individualized harm because they opted out and preserved their claims. Thus, the U.S. Trustee had standing to appeal but not the class plaintiffs.

The Constitution and Third-Party Releases

Judge Novak framed the question as whether the bankruptcy court had constitutional authority to impose third-party releases. He said that the releases covered “an extraordinarily vast range of claims held by an immeasurable number of individuals against a broad range of potential defendants.” Other than the claims against the former CEO and CFO, Judge Novak said that the bankruptcy court “ignored all of the other potential claims that it terminated in approving the releases.”

Delving into the statutory and constitutional power underlying the releases, Judge Novak said that the “bankruptcy court lacks any authority to act on it” if “the claim has no relation to a case under title 11.” In that regard, he said that the bankruptcy court “engaged in none of the content-based analysis demanded by” *Stern v. Marshall*, 564 U.S. 1058 (2011).

Judge Novak did not pause to determine whether the released claims were “core” or “noncore.” He said “it takes only a cursory review . . . to find released claims that the Bankruptcy Court lacked authority to adjudicate.” The first example he gave was the class suit against the former CEO and CFO, because the former officers had no involvement in the chapter 11 case.

Releasing claims, Judge Novak said, “amounts to adjudication of the claims for *Stern* purposes,” citing Judge McMahon’s *Purdue* opinion. He went on to say that the bankruptcy court had no *in rem* jurisdiction over third-party claims not against the estate or property of the estate.”

Referring to Section 105(a) and the plenary power of a bankruptcy court to confirm a plan, Judge Novak said that “Article III simply does not allow third-party non-debtors to bootstrap any and all of their disputes into a bankruptcy case to obtain relief.”

Next, Judge Novak dealt with the argument that the bankruptcy court had authority to issue the releases because the failure to opt out amounted to consent. He said that Supreme Court authorities “do not permit a finding of consent based on *inaction*.” [Emphasis in original.] He could not “discern any actions undertaken by the Releasing Parties to support a finding that they knowingly and voluntarily consented to Article I adjudication of the claims that they released.”

Judge Novak held that the bankruptcy court “erred in adjudicating the *Stern* claims without the knowing and voluntary consent of the Releasing Parties.”

Consequences of a *Stern* Violation

Because the bankruptcy court exceeded its power under *Stern*, Judge Novak vacated the confirmation order and treated the bankruptcy court’s decision as a report and recommendation. Saying that the bankruptcy court’s opinion “lacks any meaningful factfinding,” Judge Novak made his own factual findings based on the record from the confirmation hearing.

In the future, Judge Novak said it would “preferable” for a bankruptcy court to issue a report and recommendation, identifying “with specificity the claims and individuals released and provid[ing] detailed findings . . . to ensure that the released claims are truly integral to the reorganization.”

Judge Novak rejected the bankruptcy court’s findings and made five single-spaced pages of findings of his own. He said that the third-party releases were “nonconsensual both as a matter of fact and a matter of law.” He also found that the former CEO and CFO were not integral to the reorganization.

The Circuit Split on Third-Party Releases

Judge Novak cited the Fifth, Ninth and Tenth Circuits for prohibiting third-party releases under Section 524(e). He cited other circuits, like the Second and Third, that permit releases in rare cases.

In *Behrmann*, *supra*, the Fourth Circuit followed the test laid down by the Sixth Circuit for third-party releases. He ruled that the failure to opt out did not amount to the level of consent required by *Behrmann*.

Judge Novak said that the bankruptcy court “failed to conduct any *Behrmann* analysis.” He said that the released parties gave no substantial contribution as required by *Berhmann*. In addition, the releases were not essential to the reorganization and were not “overwhelmingly” approved by the affected class.

“Because the Plan extinguishes these claims entirely without giving any value in return, this weights strongly against granting the Releases,” Judge Novak said.

Beyond *Behrmann*, Judge Novak said that “no court” would have found the instant settlement “fair, reasonable and adequate under Rule 23.” No one represented the interests of those who were giving releases, and the releases did not result from negotiations with those on whom releases were imposed. Instead, he said, the negotiations only occurred between those who would benefit from the releases. Furthermore, he found that the releases given by the debtor to shareholders “lacked any value and [were] purely fictional.”

Judge Novak went on to hold that the third-party releases failed three of the four elements required to afford due process under Rule 23. “Accordingly,” he said, allowing releases only based on the failure to opt out “does not comport with due process.” He voided the third-party releases and held them unenforceable.

Severability

After confirmation, the plan said in substance that the releases were not severable from the remainder of the plan. Before confirmation, however, the releases were severable, Judge Novak said.

Again treating the confirmation order as a report and recommendation, Judge Novak examined the record and found that they did not “form an integral part of the Plan.” Stepping into the shoes of the bankruptcy court, he severed the releases.

Equitable Mootness

The debtors argued for dismissal of the appeal as equitably moot, but Judge Novak found four reasons why the appeal was not equitably moot.

“First and foremost,” he said, the confirmation order was no longer a final order, and equitable mootness does not apply when the confirmation order has been converted to a report and recommendation.

Second, equitable mootness does not apply when the government, via the U.S. Trustee, is representing absent individuals.

“Not only did the parties craft a release that would extinguish the rights of countless individuals, they did so in a way that would insulate the release from judicial review,” Judge Novak said. He refused to “apply the doctrine of equitable mootness against the Trustee when the Trustee seeks to protect the rights of absent individuals.”

Third, the “seriousness” of the bankruptcy court’s “errors counsels against a finding of equitable mootness.”

Fourth, effective relief was available. Judge Novak said he could sever the releases without altering any creditor’s recovery “or affect[ing] the bankruptcy estate in any way.”

Applying the factors to the appeal at hand, Judge Novak observed that equitable mootness “is all too often invoked to avoid judicial review, as Debtors seek to do here,” citing the recent Eighth Circuit opinion that limited equitable mootness dramatically. FishDish LLP v. VeroBlue Farms USA Inc. (In re VeroBlue Farms USA Inc.), 6 F.4th 880 (8th Cir. Aug. 5, 2021). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/eighth-circuit-comes-near-to-abolishing-equitable-mootness).

Judge Novak refused to allow nonseverability or equitable mootness “to preclude appellate review of plainly erroneous release provisions.”

The Exculpation Provisions

Contrasted to the releases, Judge Novak said that the plan’s exculpation provisions provided protection to “court professionals who acted reasonably while carrying out their responsibilities.”

Judge Novak remanded for the bankruptcy court to narrow the exculpation clause to cover “fiduciaries who have performed necessary and valuable duties.”

Remand

Judge Novak’s order vacated the confirmation order, voided the third-party releases, severed the third-party releases from the plan, and voided the exculpation clause.

Judge Novak remanded the case to another bankruptcy judge with instructions to redraft the exculpation clause and “then to proceed with confirmation of the Plan without the voided Third-Party Releases.”

Another Appeal?

It is unclear whether Judge Novak’s ruling is a final order appealable to the Fourth Circuit. Does the remand call for merely ministerial actions by the bankruptcy court that would allow an appeal?

The parties may not appeal again if they decide they can live without the broad releases that Judge Novak voided.

Judge-Shopping Curtailed in the E.D. of Va.

Like the Southern District of New York, the Eastern District of Virginia has adopted a local order that goes into effect on February 15: For chapter 11 debtors with more than $100 million in liabilities, the cases will be assigned randomly to a bankruptcy judge in the district without regard to the division in which the petition was filed.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Mahwah.pdf) *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167 (E.D. Va. Jan. 13, 2022).

#### At the risk of committing error, a district judge in New York reads a third-party release to cover only derivative claims, not direct claims that a creditor may have against a nondebtor.

# Another New York District Judge Is Hostile to Nondebtor, Third-Party Releases

An opinion by another district judge in New York underscores the growing hostility of Article III courts to nondebtor, third-party releases in chapter 11 plans, even plans that have been confirmed and consummated.

The reader may conclude from reading the March 8 opinion that District Judge Denise Cote was stretching the rubber band to hold that the corporate parent’s guarantee of a lease was not released by a broadly worded third-party release in the lessee’s chapter 11 plan.

The Plan and the Release

The debtor signed a three-year commercial lease. The debtor’s corporate parent issued an unconditional guarantee in favor of the landlord.

The pandemic intervened, and the debtor was never able to open a store in the leased premises. Eventually, the debtor filed a chapter 11 petition, rejected the lease and confirmed a plan.

The plan contained a release reading in pertinent part as follows:

[A]ll Persons who . . . hold Claims . . . that are subject to . . . the Plan . . . are deemed to have released the Debtor, Reorganized Debtor, the Estate and each of their affiliates, current and former officers, directors, principals, members, professionals, advisors, accountants, attorneys, investment bankers, consultants, employees, agents, and other representatives (collectively, the “Released Parties”), from any and all claims . . . , *including any direct claims held by any such Person against each Released Party* . . . whether known or unknown, . . . that each such Person would have been legally entitled to assert, . . . based on or relating to . . . the Debtor or its affiliates. [Emphasis added.]

After the plan was confirmed and consummated, the landlord sued the parent on the guarantee in district court in New York. The landlord and the parent filed cross motions for summary judgment.

The parent wins, right? The parent was an affiliate of the debtor, and the guarantee was related to the debtor. It’s open and shut, isn’t it? There was no suggestion in the opinion that the landlord was unaware of the bankruptcy or the plan. So, didn’t the plan release the landlord’s claim on the guarantee against the parent?

Answer: No. Not by a long shot.

Narrow Reading of the Plan

Tellingly, Judge Cote began her legal analysis by quoting *Metromedia* where the Second Circuit said that plans may contain third-party releases in “rare cases.” *In re Metromedia Fiber Network*, 416 F.3d 136, 141 (2d Cir. 2005). Later in the opinion, she would remark how the parent never explained “why this is one of the ‘rare cases’ in which a nondebtor release would be essential to the reorganization plan.”

Focusing on the plan, Judge Cote said that releases in favor of officers, directors and other entities had to do their potential liability on derivative claims. The landlord’s claim, she said, was not derivative. It was direct and primary.

However, the plan explicitly released creditors’ direct claims. In other words, without saying so directly, Judge Cote was at least suggesting that a nondebtor release may only pertain to derivative claims.

Next, Judge Cote focused on the word “affiliate,” because the plan broadly released claims against the debtor’s affiliates.

The parent alluded to the definition of “affiliate” in Section101(2)(A), which includes an entity controlling at least 20% of a debtor’s voting securities. Wouldn’t “affiliate” cover the parent?

No, Judge Cote said. The definition in Section 101(2)(A) was “irrelevant” because the plan said that capitalized terms would have the meaning given in the Bankruptcy Code. In the plan, “affiliate” bore a lower case “a.”

Judge Cote cited an authority that distinguishes between affiliates and parents.

In addition, the plan several times referred to “Parent.” Judge Cote said that the drafters of the plan knew how to refer to the parent but didn’t when it came to the releases.

Next, Judge Cote said that adoption of the parent’s interpretation of the plan “would lead to extreme results.” She said that the broad language in the plan would release any claim that any creditor had against the parent, “regardless of whether that claim had anything to do with [the debtor].”

We heard the same refrain in the district court’s opinion overturing confirmation of the chapter 11 plan of Mahwah Bergen Retail Group Inc. and affiliates. *See* *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167, 2022 BL 13068, 2022 US Dist. Lexis 7431 (E.D. Va. Jan. 13, 2022). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/another-district-judge-emphatically-rejects-a-plan-with-non-debtor-third-party).

[Note: This writer reads the release quoted above as only releasing a claim that a creditor had against the parent if that claim was related to the debtor.]

Because it was not a “rare” case, Judge Cote ruled that the landlord was entitled to enforce the guarantee against the parent.

Before entering summary judgment against the parent for more than $2 million, Judge Cote dismissed the parent’s other affirmative defenses, including failure of consideration and impossibility of performance.

Observations

Looking only at the language of the release in view of the finality of the plan, Judge Cote’s ruling might be upset on appeal.

However, an appellate court might find other reasons to affirm.

Notably, the plan released the landlord’s direct claim against the parent seemingly without additional consideration. Releases of that sort stuck in the craw of District Judge Colleen McMahon of Manhattan when she overturned confirmation in *In re Purdue Pharma LP*, 635 B.R. 26 (S.D.N.Y. Dec. 16, 2021). However, there was a timely appeal in *Purdue,* and the plan had not been consummated. To read ABI’s report on *Purdue*, [click here](https://www.abi.org/newsroom/daily-wire/third-party-non-consensual-releases-nixed-in-the-purdue-%E2%80%98opioid%E2%80%99-reorganization).

Perhaps the bankruptcy court lacked subject matter jurisdiction or constitutional power on its own to release direct claims. Perhaps a circuit court would say that a plan provision is unenforceable if the bankruptcy court lacked constitutional power under *Stern*.

What we are seeing is Article III courts’ animosity toward third-party releases. This writer recommends that bankruptcy courts sense which way the wind blows and trim third-party releases back to the bone before circuit courts or Congress toss them out altogether.

[The opinion is](https://abi-opinions.s3.amazonaws.com/605+Fifth.pdf) *605 Fifth Property Owners LLC v. Abasic S.A.*, 21-811 (S.D.N.Y. March 8, 2022).

#### Mallinckrodt’s nondebtor releases didn’t have the defects that infected Purdue and Patterson.

# Horizontal ‘Gifting’ Approved in Mallinckrodt’s Confirmed Chapter 11 Plan

On top of crippling opioid liability, drug-producer and distributor Mallinckrodt was saddled with securities class actions and lawsuits by governmental units regarding a different drug called Acthar. The chapter 11 petition filed in October 2020 was the only hope for avoiding slow corporate death and liquidation from insufferable litigation costing $1 million a week.

Before and after filing, the debtor hashed out settlements and a chapter 11 plan that garnered approval from every fiduciary, almost every organized creditor group and 88% of voting creditors. The plan has $1.725 billion in cash, new secured notes, warrants and other consideration parceled out among the creditor classes.

Of course, there were dissenters, including the U.S. Trustee, the Securities and Exchange Commission and classes deemed to reject the plan. With a minor modification of exculpations that were overly broad, Bankruptcy Judge John T. Dorsey of Delaware confirmed the plan in a 98-page opinion on February 3.

The confirmed plan had nondebtor, third-party releases. However, the alleged shortcomings in Mallinckrodt’s plan did not rise to the level that recently resulted in reversals of confirmation in New York and Virginia. *See* *In re Purdue Pharma LP*, 21-07532, 2021 BL 482465, 2021 WL 5979108, 2022 US Dist Lexis 8160 (S.D.N.Y. Dec. 16, 2021); and *Patterson v. Mahwah Bergen Retail Group Inc.*, 21-167, 2022 BL 13068, 2022 US Dist Lexis 7431 (E.D. Va. Jan. 13, 2022). To read ABI’s reports, [click here](https://www.abi.org/newsroom/daily-wire/third-party-non-consensual-releases-nixed-in-the-purdue-%E2%80%98opioid%E2%80%99-reorganization) and [here](https://www.abi.org/newsroom/daily-wire/another-district-judge-emphatically-rejects-a-plan-with-non-debtor-third-party).

Although some may disagree, Mallinckrodt’s plan would not have been offensive to the district judge in *Purdue*, because it did not release creditors’ nonderivative, direct claims against nondebtors. Although subject more to doubt, Mallinckrodt’s plan might not have offended the district judge in *Patterson*, because the creditor groups giving nondebtor releases negotiated the plan and are receiving substantial recoveries.

However, the district judge in *Patterson* might believe that Judge Dorsey erred in ruling that the bankruptcy court had constitutional power to issue releases in favor of third parties.

Mallinckrodt’s plan is notable in several respects, according to Prof. Bruce A. Markell. He told ABI:

The opinion accomplishes everything I would want, but very little I would grant. It tackles all the current hot-buttons of mass tort reorganization — third party releases, consents obtained through the use of opt-outs, and validation of gifting that freezes out identifiable classes to the benefit of those favored by the donor — and resolves each of them in favor of the debtor’s reorganization. Unfortunately, I disagree that the reorganization achieved is one anticipated or authorized by the Code. The result may be the best one possible on utilitarian grounds, but those grounds are not written into the Code nor have they been embraced or enacted by Congress.

Prof. Markell is the Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law.

Chapter 11 practitioners should set aside several hours to read the opinion in full text.

Nondebtor Releases

The plan releases claims against nondebtors, such as officers and directors. Unlike *Millennium Lab Holdings II, LLC*, 945 F.3d 126 (3d Cir. 2019), where shareholder defendants paid $325 million for their releases, the U.S. Trustee opposed the releases because the released third parties are paying nothing for theirs. For ABI’s report on *Millennium*, [click here](https://www.abi.org/newsroom/daily-wire/third-circuit-finds-constitutional-power-to-grant-releases-in-confirmation).

Judge Dorsey noted that the third-party releases were negotiated, to a large extent, with fiduciaries for claimants giving the releases. Were there no releases, he said that the debtor would be dragged back into litigation in view of indemnification rights. If there were continued litigation and no settlements and releases, Judge Dorsey concluded that claimants would have lower recoveries because the debtor would end up in liquidation.

With regard to releases that might be nonconsensual for some classes, Judge Dorsey said it was “exactly the type of extraordinary case the Third Circuit alluded to in *Continental*, where nonconsensual releases might be appropriate.” For the classes that negotiate the settlements and releases, he said they were “both necessary and fair” and “overwhelmingly supported by the creditor body.”

To the argument that the bankruptcy court lacked statutory or constitutional power, “the fact is,” Judge Dorsey said, “that only one single creditor out of hundreds of thousands actually objected to these releases. To apply a blanket prohibition on non-consensual releases in this case would simply not make sense.”

Opting Out

The Securities and Exchange Commission and the U.S. Trustee objected to releases on the part of shareholders, arguing that the releases were impermissibly nonconsensual because the class was deemed to reject the plan. They contended that the ability to opt out did not make the releases consensual and subjected the releases to the *Continental* test.

Despite the debtor’s extensive trolling for opt-outs, Judge Dorsey said there had only been 2,200. Conceding that not all courts agree, he decided “that they are appropriate.” He noted that the plan was “supported by every estate fiduciary, almost every organized creditor group, and 88% of voting creditors.”

Unfair Discrimination, Horizontal Gifting

The so-called waterfall proffered by the debtor indicated that some subgroups of unsecured creditors would receive no recovery if distributions were made solely in accordance with bankruptcy priorities. Significantly, unsecured noteholders held guarantees from all of the myriad debtor entities. Other unsecured creditor groups might have recourse against only one debtor entity with little value.

The waterfall revealed that unsecured noteholders would be entitled to $1.4 billion. Under the same scenario, other general unsecured creditors receive $22.5 million, but only three of the seven subclasses would receive anything at all.

“To avoid litigation with constituents in the other unsecured classes and facilitate settlements,” Judge Dorsey said that the noteholders “agreed to reallocate or ‘gift’ $228.5 million of their Entitled Recovery” to other classes of unsecured creditors.

As a result, Judge Dorsey said one subclass of unsecured creditors with $41 million in claims would have its recovery rise from 1% to 100%. Another subclass would go from nothing to 4%.

To analyze the propriety of gifting in the case before him, Judge Dorsey adopted the test proffered by Prof. Markell and decided there was a rebuttable presumption of gifting that would amount to unfair discrimination prohibited by Section 1129(b)(1).

On the question of unfair discrimination, Judge Dorsey found none, because the debtor had rebutted the presumption. He cited Third Circuit authority and said it is “irrelevant” when one “out of the money unsecured creditor class is doing better” than another out-of-the-money creditor.

Observations

Prof. Markell is the leading scholarly authority among those who believe that gifting is not permitted by the Bankruptcy Code. His commentaries are to be found in Bruce A. Markell, “A New Perspective on Unfair Discrimination in Chapter 11,” 72 *Am. Bankr. L.J.* 227 (1998); and Bruce A. Markell, “The Clock Strikes Thirteen: The Blight of Horizontal Gifting,” 38 *Bankr. L. Ltr.* 12 (Dec. 2018). To read his more recent discussion, [click here](https://abiworld.app.box.com/file/914842965479).

In his later work on horizontal gifting, like that afoot in Mallinckrodt’s plan, Prof. Markell contends there is no gift. Rather, he says, the gift-giver is obtaining releases and injunctions and a shorter path to confirmation. He said, “Creditors ought not to be able to change results Congress picked by bribes to out-of-the-money classes.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/MALLINCKRODT+confirm.pdf) *In re Mallinckrodt PLC*, 20-12522 (Bankr. D. Del. Feb. 3, 2022).

#### The first court of appeals to reach the issue decides that the SBA properly interpreted the CARES Act to bar chapter 11 debtors from receiving PPP ‘loans.’

# Second Circuit Holds that Debtors Are Properly Barred from Receiving PPP Loans

On an issue where the lower courts are divided, the Second Circuit became the first court of appeals to rule that a “loan” under the Paycheck Protection Program, “as a matter of law, . . . is a loan guaranty program and not an ‘other similar grant,’ and thus is not covered by [the antidiscrimination provision in] Section 525(a)” of the Bankruptcy Code.

In other words, the Small Business Administration properly barred companies in chapter 11 from receiving PPP “loans,” according to a March 16 opinion by Circuit Judge Joseph F. Bianco.

The Debtor Wins in Bankruptcy Court

The Paycheck Protection Program, or PPP, was part of the $2.2 trillion Coronavirus Aid, Relief and Economic Security Act (CARES Act), which became law in March 2020. Although denominated as a loan, it will be forgiven if the proceeds are spent on eligible expenses like payroll and rent.

A hospital in Vermont was in chapter 11 and applied for a PPP loan. The Small Business Administration denied the loan solely because the debtor answered “yes” to a question on the loan application asking whether the borrower was in bankruptcy.

The debtor sued the SBA in bankruptcy court, where the judge decided that a PPP “loan” was a “grant” protected by the antidiscrimination provision in Section 525(a). The bankruptcy court granted summary judgment in favor of the debtor and entered a permanent injunction requiring the SBA to make the loan. *Springfield Hospital Inc. v. Carranza (In re Springfield Hospital Inc.)*, 618 B.R. 70 (Bankr. D. Vt. June 22, 2020). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/government-notches-4-victories-debtors-win-once-in-fights-over-ppp-%E2%80%98loans%E2%80%99).

The bankruptcy court authorized a direct appeal, which the Second Circuit accepted.

The Circuit Sides with the Majority

In his 53-page opinion, Judge Bianco said that 18 courts to date have ruled that the PPP is not protected by Section 525(a), while six courts have decided that the section requires the SBA to grant loans to businesses in chapter 11.

Principally, Judge Bianco found the answer in the plain language of Section 525(a), which provides:

[A] governmental unit may not deny . . . a license, permit, charter, franchise, or other similar grant to . . . a person that is or has been a debtor under this title . . . .

A PPP loan was not a license, permit, charter or franchise. Judge Bianco therefore focused on whether it was a “grant,” a word not defined in the statute.

Two Second Circuit decisions were controlling: *In re Goldrich*, 771 F.2d 28 (2d Cir. 1985), and *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 90 (2d Cir. 2002). In *Goldrich*, the circuit held that Section 525, as it was then written, did not cover a guaranteed student-loan program.

Almost a decade after *Goldrich*, Judge Bianco said that “Congress amended Section 525 to include a subsection prohibiting discrimination against debtor-borrowers by any ‘governmental unit that operates a student grant or loan program.’ 11 U.S.C. § 525(c).”

In *Stoltz*, the Second Circuit held that a lease for a public housing unit was a “grant” protected by Section 525(a).

Taken together, Judge Bianco said that the two opinions mean that a “grant” is something that is “‘unobtainable from the private sector’ [and] ‘essential to a debtor’s fresh start.’ *Stoltz v. Brattleboro Hous. Auth. (In re Stoltz)*, 315 F.3d 80, 90 (2d Cir. 2002).”

Judge Bianco said that *Goldrich*, which precluded loans from coverage in Section 525(a), remained good law after *Stoltz.* He said that the amendment to Section 525 “narrowly abrogated *Goldrich’*s specific holding as to *student* loans but had not abrogated its broader holding that Section 525(a) did not cover loans in general.” [Emphasis in original.]

“[W]e reaffirm here,” Judge Bianco said, “that the plain text of Section 525(a) does not cover loan programs.”

PPP ‘Loans’ Aren’t Grants

Even if loans are not protected by Section 525(a), the debtor contended that PPP loans are actually grants.

Judge Bianco disagreed. He said that the CARES Act refers to PPP loans as “loans” 75 times. Furthermore, he said, the forgiveness of PPP loans is “neither automatic nor guaranteed.”

Judge Bianco again referred to the dual standards in *Goldrich/Stoltz*. Unlike the refusal to grant a license that would put a company out of business, he said that the refusal of the SBA to grant a loan does not exclude a debtor “from receiving capital from other sources,” nor is an SBA loan “essential to a debtor’s fresh start.”

Subsequent Legislation

Although Judge Bianco found the answer in the plain language of the statute, he said that “the additional PPP legislation enacted after the Cares Act provides further support for our interpretation of Section 525(a).”

In the Consolidated Appropriations Act of 2021, he said,

Congress amended Section 525 to expressly bar discrimination based on bankruptcy status in the provisioning of certain Cares Act benefits — such as foreclosure moratoriums, 15 U.S.C. § 9056, forbearance of certain residential mortgages, *id.* § 9057, and eviction moratoriums, *id.* § 9058 — but notably did *not* include PPP loans in this amendment. [Emphasis in original.]

Judge Bianco drew a “clear negative inference from this amendment . . . that other provisions of the Cares Act are *not* covered by Section 525(a).” [Emphasis in original.]

Judge Bianco vacated the permanent injunction and remanded with instructions that the SBA was entitled to summary judgment in its favor. However, he did not rule on whether the SBA was “immune from injunctive relief” under Section 634(b)(1) of the Small Business Act.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Springfield+Hospital.pdf) *Guzman v. Springfield Hospital Inc.*, 20-3902 (2d Cir. March 16, 2022).

#### Circuit Judge Loken predicts the Supreme Court will abolish equitable mootness if the lower courts don’t cut back and start reviewing the merits of confirmed chapter 11 plans.

# Eighth Circuit Comes Near to Abolishing Equitable Mootness

The Eighth Circuit has come one step short of altogether abolishing the judge-made doctrine of equitable mootness.

Strictly speaking, the appeals court barred dismissal of an appeal from confirmation of a chapter 11 plan without

at least a preliminary review of the merits of [the appellant’s] appeal to determine the strength of [the appellant’s] claims, the amount of time that would likely be required to resolve the merits of those claims on an expedited basis, and the equitable remedies available — including possible dismissal — to avoid undermining the plan and thereby harming *third parties*. [Emphasis in original.]

The St. Louis-based court of appeals did ban further use of the term “equitable mootness” in the Eighth Circuit, telling courts instead to say “equitable dismissal.”

The Complex, Hard-Fought Chapter 11 Case

The case was a typical blood-and-guts reorganization of a large company. The original start-up capital was $63 million in debt and equity, with further investments down the road. At filing, the first-lien debt was $54 million, more than the assets were worth. The debt was secured by all the assets.

The chapter 11 case began with a $2 million “DIP” loan made by the largest equity holder. It was a so-called priming lien ahead of all other debt. In return for being primed, the first-lien secured lender was given an adequate protection lien.

In addition, the financing order included a so-called challenge deadline requiring the official creditors’ committee to raise an objection to the prebankruptcy secured debt before a specified date. In the absence of a timely objection by the *creditors’ committee*, the secured debt would be an allowed claim subject to no further challenge or objection.

The official creditors’ committee lodged a timely objection, demanding that the debtor initiate an adversary proceeding against the secured lender and the dominant equity holder. The next day, an unofficial, *ad hoc* group of equity holders joined in the creditors’ objection.

The creditors’ committee reached a settlement on a chapter 11 plan. In return for a dollop of consideration for unsecured creditors, the committee dropped its objection to the secured claim. The bankruptcy court soon after ruled that secured debt was sacrosanct because there had been no timely objection.

Then, one of the smaller equity holders objected to the disclosure statement and to allowance of the secured claim. The bankruptcy court confirmed the plan and denied the objection to the secured claim.

You know what happened next, and quickly. The plan was consummated. Among other things, the dominant equity holder funded the plan with $13.5 million, existing stock was cancelled, cash distributions were made to creditors, and the secured lender received $6 million.

Having objected unsuccessfully to the secured claim, the smaller equity holder appealed the confirmation order, claiming unfair discrimination between creditors of the same class, violation of the absolute priority rule, bad faith, and failure to meet the best interests test.

The district court dismissed the appeal as equitably moot, but the equity holder appealed to the circuit.

Predicting the Demise of Equitable Mootness

In his 16-page opinion on August 5, Circuit Judge James B. Loken reversed and remanded for reconsideration of the merits, at least to a limited extent. His opinion is a “must read” for anyone involved in chapter 11 practice. He wrote a compendium of the best objections to the survival of equitable mootness.

If the doctrine becomes embedded in appellate jurisdiction, “rather than an exception to the Article III-based rule that jurisdiction should be exercised,” he “predict[ed] [that] the Supreme Court, having up to now denied petitions for *certiorari* to review the doctrine, will step in and severely curtail ̶ perhaps even abolish ̶ its use, just as the Court curtailed lower courts’ excessive use of the ‘*Rooker-Feldman* doctrine’ to avoid difficult claim and issue preclusion analysis.”

Insiders Aren’t Protected by Equitable Mootness

Judge Loken began his analysis by saying that equitable mootness “is misleading.” Consequently, “we banish ‘equitable mootness’ from the (local) lexicon,” he said.

Judge Loken explained that an appeal is “moot, that is, beyond a federal court’s Article III jurisdiction, only if ‘it is impossible for a court to grant any effectual relief whatsoever,’” quoting *Mission Prod. Holdings Inc. v. Tempnology* *LLC*, 139 S. Ct. 1652, 1660 (2019).

As for equitable mootness, he said the doctrine has been “adopted by our sister circuits (though not uniformly).” The Eighth Circuit had not taken a position except in a nonprecedential opinion upholding the doctrine without discussion.

Equitable mootness, Judge Loken said, “has been thoughtfully criticized by many judges.” He heaped praise on the concurrence by Circuit Judge Cheryl Krause in *In re One2One Communications LLC*, 805 F.3d 428 (3d Cir. 2015), where the Third Circuit reversed an equitable mootness dismissal and remanded for reconsideration of the merits.

Judge Loken quoted Judge Krause as follows:

[A] motion to dismiss an appeal as equitably moot has become “part of the Plan.” Proponents of reorganization plans now rush to implement them so they may avail themselves of an equitable mootness defense, much like Appellees did here. Rather than litigate the merits of an appeal, parties then litigate equitable mootness. And even if an appeal is dismissed as equitably moot by a district court, that dismissal is appealed to our Court, often resulting, in turn, in a remand and further proceedings . . . . Without the equitable mootness doctrine, on the other hand, the District Court would have ruled on the merits long ago. *Id*. at 446-7.

In the case before him, Judge Loken said that half of the cash distribution went to the secured lender whose lien was being challenged by the minority shareholder. The lender and the plan sponsor, he said, “are not third parties that the equitable mootness doctrine is intended to protect.”

Again quoting Judge Krause, Judge Loken said that the case on appeal dealt with complex questions like compliance with cramdown provisions and claims of conflict of interest or preferential treatment “that go to the very integrity of the bankruptcy process.” *Id*. at 454. The appeal before him, Judge Loken said, “takes on the look of the type of Chapter 11 plan that Judge Krause defined as one needing review on the merits by an Article III appellate court.”

Judge Loken reversed on equitable mootness and remanded. He did not tell the district court how to rule on the merits of the plan, saying that we only “decide that the inquiry must be made.”

However, Judge Loken did say that “if the confirmed plan must be set aside on the merits, the district court may be able to fashion effective relief for those whose rights were impaired by the plan even if the business assets have been sold to a third party purchaser relying on the confirmed plan, such as disgorgement of the proceeds.”

Observations

Judge Loken seems to require that appellate courts take four steps on appeal from confirmation of a chapter 11 plan: The appellate court must (1) accelerate the appeal; (2) undertake a preliminary review of the objections to confirmation; (3) decide how long it would take to resolve the merits of the appeal on an expedited basis; and (4) evaluate available remedies that would not harm third parties.

The opinion could mean that parties central to the reorganization, including plan sponsors and major secured creditors, are not entitled to protection by equitable dismissal. The doctrine in the Eighth Circuit seems to protect only true third parties not involved in maneuvering to confirm the plan.

The opinion will have its effects. Sad to say, the Eighth Circuit may take on a stigma worse than those (increasingly fewer) circuits proscribing non-debtor, third-party releases.

The divergence among the circuits on equitable mootness is good reason for the Supreme Court to grant *certiorari* in the next term and resolve the issue once and for all. As it stands now, many of the most consequential questions about chapter 11 plans defy appellate review on authority of equitable mootness.

The two petitions now before the Court on equitable mootness are *GLM DWF Inc. v. Windstream Holdings Inc.*, 21-78 (Sup. Ct.); and *Hargreaves v. Nuverra Environmental Solutions Inc.*, 21-17 (Sup. Ct.). [Click here](about:blank) to read yesterday’s Rochelle’s Daily Wire regarding the *certiorari* petitions.

[The opinion is](about:blank) *FishDish LLP v. VeroBlue Farms USA Inc. (In re VeroBlue Farms USA Inc.)*, 19-3413, 2021 BL 294741, 2021 Us App Lexis 23164 (8th Cir. Aug. 5, 2021).

#### Although Section 1141(d)(1) sets a default rule only discharging claims that arose before confirmation, Circuit Judge Ambro says that a plan may alter the default rule and allow discharge of administrative claims arising after confirmation.

# Chapter 11 Plans May Discharge Post-Confirmation ‘Admin’ Claims, Third Circuit Says

The first among the courts of appeals to rule on the issue, the Third Circuit held that an administrative claim arising between confirmation and the effective date of a chapter 11 plan must be filed before the administrative bar date to avoid being discharged.

In his August 30 opinion, Circuit Judge Thomas L. Ambro said that “holders of post-confirmation, pre-effective date administrative expense claims are bound by a bar date like other holders of claims against the estate, and thus they cannot choose to bypass the bankruptcy process altogether.”

The result, Judge Ambro said, is “supported by [the] principal purpose of granting the debtor a fresh start.” A debtor “still needs comfort [that] administrative expense claims will not come out of the woods later to assert them against the reorganized debtor.”

The Plan and the ‘Admin’ Claim

The corporate debtor confirmed a chapter 11 plan. The plan said that administrative expense claims must be filed before a specified date, which we shall refer to as the “admin bar date.” Naturally, the plan also said that all claims would be discharged on the effective date of the plan.

One of the debtor’s executives was fired two months after confirmation. The firing took place two months before the plan became effective and about three months before the admin bar date.

The effective date of the plan had been delayed given the need for governmental regulatory approvals. The debtor said it had given the executive notice of the admin bar date. The executive had also received notices about the general bar date and the deadlines for voting and objecting to confirmation.

After being fired, the 67-year-old executive immediately hired a lawyer, believing that his firing was the result of age discrimination. He filed a complaint with the Equal Employment Opportunity Commission before the admin bar date. He filed suit in federal district court about two months after the admin bar date. The plan’s effective date occurred about two months after the executive was fired. He did not file an administrative claim before or after the admin bar date.

The debtor filed a motion for summary judgment in district court, contending that the claim was discharged because the executive had not filed a claim in bankruptcy court before the admin bar date. The district court denied the debtor’s motion but granted the executive’s motion for summary judgment, holding that Section 503 does not authorize a bar date to discharge post-confirmation administrative claims.

The district court also held that Section 1141(d) prohibits the discharge of post-confirmation claims.

The district court authorized an interlocutory appeal, which the Third Circuit accepted.

Plans May Alter the Default Rule in Section 1141(d)(1)

Methodically, Judge Ambro dissected the issues leading to his conclusion that the plan discharged post-confirmation-but-pre-effective-date administrative claims. First, he addressed the question of whether a post-confirmation claim is an administrative expense of the chapter 11 case.

The district court had held that the claim was an administrative expense but was not discharged. Judge Ambro found no textual support for the holding. He said that a “claim is either an administrative expense claim or it is not; it cannot be a chameleon.”

Judge Ambro went on to say:

[T]he District Court’s position that the claim is entitled to administrative priority, but not subject to discharge, is untenable, as that would allow creditors to cherry-pick whether they want to recover from the estate or the reorganized debtor.

Recognizing that the chapter 11 estate was still in existence when the claim arose, Judge Ambro held that the “claim is thus an administrative expense claim under § 503 and subject to the Administrative Claims Bar Date.”

Citing the *Collier* treatise, Judge Ambro next held that Section 503 authorizes bankruptcy courts to set and enforce bar dates for administrative expense claims. He said that bar dates for administrative claims “help the debtors know their liabilities and implement a viable plan to obtain a fresh start.”

Judge Ambro turned to the question of whether Section 503 permits courts to discharge post-confirmation administrative claims. In that regard, the district court had held that a bankruptcy court cannot set a bar date for post-confirmation administrative claims.

Judge Ambro said that “Section 503 recognizes no such limitation, and we generally refrain from adding words to a statute.” He said that Section 503 works in tandem with Section 1141(d) by allowing bankruptcy courts “to set and enforce bar dates,” while Section 1141(d) allows the plan and a confirmation order “to govern the discharge of claims (with a few exceptions).”

Last, Judge Ambro held that Section 1141(d) does not prohibit the discharge of post-confirmation claims.” Rather, it sets a default rule “that can be overridden by the plan and confirmation order.”

The district court had held that Section 1141(d)(1) precludes the discharge of post-confirmation claims. The section says:

Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan —

(A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section 502(g),502(h), or 502(i) of this title . . . ; and

(B) terminates all rights and interests of equity security holders and general partners provided for by the plan.

Disagreeing with the district court, Judge Ambro read the section as creating

a default rule for discharging pre-confirmation debts, meaning it applies only when the plan and confirmation order are silent on the issue. Here the Plan provided for the discharge of postconfirmation claims not timely filed by the Administrative Claims Bar Date. This overrides the default rule in § 1141(d)(1).

Judge Ambro reversed the district court but said that the decision would not prevent the executive from asking the bankruptcy court to accept a late-filed claim for cause under Section 503(a).

[The opinion is](about:blank) *Westinghouse Electric Co. LLC v. Ellis*, 20-2867, 2021 BL 326588, 2021 Us App Lexis 26092 (3d Cir. Aug. 30, 2021).

#### The Third Circuit made more rules to decide whether an insurance company can be insulated from failure-to-warn claims by the channeling injunction in a chapter 11 ‘asbestos’ plan.

# Third Circuit Makes More Rules on the Proper Scope of Asbestos Channeling Injunctions

For a second time in three years, the Third Circuit declined to rule on whether an insurance company is protected by the so-called channeling injunction in the “asbestos” plan confirmed by W.R. Grace & Co. 10 years ago, in a chapter 11 reorganization begun 20 years ago.

Simplified, the September 15 opinion by Circuit Judge Julio M. Fuentes remanded the case for the bankruptcy judge to decide as a fact-finding matter whether providing workplace inspections was an obligation imposed on the insurance company by the insurance policies. If the services weren’t required by the policies, the insurance company was not protected by Grace’s chapter 11 plan and must face lawsuits lodged by workers at the company’s asbestos mine.

Warning: Only asbestos mavens should read this story. For anyone else, it’ll induce a fatal attack of narcolepsy.

The Prior Appeal

The Grace plan created a trust to pay asbestos claims and contained a channeling injunction protecting both the debtor and its insurers under Section 524(g).

In a decision three years ago, Third Circuit Judge Thomas L. Ambro described a channeling injunction as one “that channels [asbestos] liability to a trust set up to compensate persons injured by the debtor’s asbestos.” He said it “can also protect the interests of non-debtors, such as insurers.” *In re W.R. Grace & Co.*, 900 F.3d 126, 129 (3d Cir. 2018). To read ABI’s report on the prior decision, [click here](https://www.abi.org/newsroom/daily-wire/third-circuit-explores-the-limits-of-channeling-injunctions-protecting-insurers).

Giving rise to the prior appeal and the new one, asbestos claimants had sued an insurance company that provided Grace with workers’ compensation and employers’ liability coverage, based on the insurer’s right but not obligation to inspect the company’s facilities.

After the plaintiffs sued in Montana state court, the insurance company sought a declaratory judgment in bankruptcy court in Delaware. The bankruptcy court granted the insurer’s motion for summary judgment and ruled that the channeling injunction enjoined the plaintiffs from suing the insurance company.

On the prior appeal, Judge Ambro upheld the bankruptcy court’s conclusion that the insurance company’s policies were covered by the channeling injunction. However, that wasn’t the end of the story, because a channeling injunction can go no further than Section 524(g) allows in protecting non-debtor third parties.

Judge Ambro remanded the case to the bankruptcy court to decide whether the injunction exceeded the limits laid down by Section 524(g).

Citing Section 524(g)(4)(A)(ii) and providing guidance for the bankruptcy court on remand, Judge Ambro said that the claims must arise “‘by reason of’ one of four statutory relationships between the third party and the debtor” before a channeling injunction can protect a third party. *Id*. at 135. Judge Ambro examined two of the four.

First, Judge Ambro examined whether the Montana claimants were seeking to hold the insurance company “directly or indirectly liable for the conduct of, claims against, or demands on” Grace, as specified in Section 524(g)(4)(A)(ii). He said that the statute limits the permissible scope of the injunction to claims based on derivative liability, meaning that the insurance company’s liability must “arise by reason of” the provision of insurance to Grace.

Judge Ambro remanded the case to the bankruptcy court, saying that the “proper inquiry is to review the law applicable to the claim being raised against the third party (and when necessary to interpret state law) to determine whether the third-party’s liability is wholly separate from the debtor’s liability or instead depends on it.” *Id*. at 137.

Next, Judge Ambro analyzed the so-called statutory relationship requirement, also in Section 524(g)(4)(A)(ii). He remanded the case for the bankruptcy judge to review “the applicable law to determine the relationship’s legal relevance to the third-party’s alleged liability.” *Id*. at 138. He said that the bankruptcy court should “examine the elements necessary to make [a claim under Montana law] and determine whether [the] provision of insurance to Grace is relevant legally to these elements.” *Id*.

The Decision Remand

On remand, the plaintiffs contended that the insurers were negligent and failed to warn about the dangers of exposure to asbestos. In substance, the bankruptcy judge concluded that the negligence and failure-to-warn claims were not derivative in nature and were therefore not subject to the channeling injunction.

The bankruptcy judge authorized the plaintiffs to continue litigation against the insurers in Montana state court. *Continental Casualty Co. v. Carr (In re W.R. Grace & Co.)*, 607 B.R. 419 (Bankr. D. Del. Sept 23, 2019). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/another-court-limits-%E2%80%98related-to%E2%80%99-jurisdiction-based-on-indemnification-claims).

Naturally, the insurance company appealed. The case was heard by a different panel.

Ruling on the new appeal, Judge Fuentes said that the bankruptcy court had “misapplied our guidance.” Like the bankruptcy court, he held that the plaintiffs’ claims meet the “derivative liability requirement,” but the record did not permit the circuit court to decide whether the claims “meet the statutory relationship requirement.”

He was careful to say that the bankruptcy court is not required to decide the state-law claims on the merits.

Derivative Liability Requirement

The outcome of the appeal turned on Montana law, which, in turn, follows Section 324A of the Restatement (Second) of Torts, dealing with liability to third persons other than the intended beneficiary of the contractual undertaking. In short, the insurance company’s liability under the Restatement turns on whether its liability is dependent on Grace’s liability or wholly separate from it.

It was “indisputable,” Judge Fuentes said, that the injuries were caused by Grace’s conduct. Therefore, the insurance company’s liability was not “wholly independent” of Grace’s.

Judge Fuentes therefore agreed with the bankruptcy court that the circumstances met the derivative liability requirement.

But there’s more.

Statutory Relationship

With regard to Section 324(g)’s requirement of a statutory relationship, the bankruptcy court decided that the requirement was not satisfied because providing insurance to Grace had no relevance to the insurance company’s liability under the Restatement or state law.

Judge Fuentes disagreed. He said:

[T]he appropriate question is whether the Montana Plaintiffs have made a prima facie case that [the] provision of insurance was legally relevant to [the insurance company’s] allegedly negligent undertaking of industrial hygiene and medical monitoring services. Or, put another way, whether they have shown that the services allegedly provided by [the insurance company] were incidental to its provision of insurance.

Judge Fuentes had a narrower understanding of Montana law than the insurance company. State law, he said, only requires that the insurance company affirmatively undertook to render services to a third party and that it should have recognized that the services were necessary for the protection of others.

“In other words,” Judge Fuentes said, the Restatement “is unconcerned with why [the insurance company] undertook to render services; only that it did so.”

The record, Judge Fuentes said, did not show whether the services provided by the insurance company were “within the scope of its provision of services to Grace.” There was no evidence, he said, as to whether inspections or loss-control recommendations are generally central to insurance underwriting and risk management. Likewise, the appeals court did not know whether “industrial-hygiene services of the type” were standard insurance-related services.

Even if the circuit court knew the industry standard, Judge Fuentes said that the record did not show whether the services were within the scope of the Grace policies. In that regard, the appeals court only had the policy that said that the insurance company was permitted, but not obligated, to inspect the facilities.

Judge Fuentes remanded for the bankruptcy court to make factual findings “as to what services were included in [the] provision of insurance to Grace, and whether the Montana Plaintiffs have made a prima facie showing under Montana law that [the insurance company] provided services beyond these.”

If the insurance company provided services beyond the policy, Judge Fuentes said that “the Montana Claims do not meet the statutory relationship requirement; if not, however, then the claims at issue meet all of the requirements of § 524(g) and are barred by the channeling injunction.”

After remand, Judge Fuentes said that the panel “will retain jurisdiction over any future appeals.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/WR+Grace+3cir+Sept+2021.pdf) *Continental Casualty Co. v. Carr (In re W.R. Grace & Co.)*, 20-2171 (3d Cir. Sept. 15, 2021).

#### Maryland district judge predicts that the Fourth Circuit would adopt a debtor-friendly rule more broadly discharging environmental claims when the acts occurred before chapter 11.

# Fourth Circuit Would Discharge CERCLA Claims if Pollution Occurred Before Filing

Predicting how the Fourth Circuit would rule at the intersection of environmental and bankruptcy law, District Judge Stephanie A. Gallagher of Baltimore held that claims for environmental pollution are discharged if the pollution occurred before the chapter 11 filing.

In her October 12 opinion, Judge Gallagher said that environmental claims are discharged even if response costs were not incurred until after bankruptcy and even if the debtor was not identified as a potentially responsible party until after bankruptcy.

The opinion is notable for Judge Gallagher’s succinct summary of the three approaches courts have taken to decide whether environmental liabilities are discharged in bankruptcy. Under at least one of the theories, the debt would not have been discharged.

CERCLA Response Costs Incurred After Discharge

The facts were straightforward and typical of many environmental claims arising in bankruptcy under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, or CERCLA.

Between the 1950s and the early 1970s, the corporate debtor deposited hazardous chemicals in a landfill. The debtor filed a chapter 11 petition in 1992 and confirmed a chapter 11 plan the same year.

The U.S. Environmental Protection Agency gave notice in 1999 to potentially responsible parties, or PRPs. The debtor had not been identified as a PRP before bankruptcy.

In 2017, the EPA entered into a consent decree with some of the PRPs, whom we shall refer to as the settling defendants. The settling defendants did not begin incurring response costs until 2006.

In Judge Gallagher’s court, the settling defendants sued the debtor in 2000 for its share of the response costs incurred under the consent decree. The debtor filed a motion for summary judgment, contending that the 1992 chapter 11 discharge cut off liability. The settling defendants argued that the debt was not discharged because they had not begun incurring response costs until 14 years after discharge.

Judge Gallagher agreed with the debtor, granted the motion and dismissed.

‘Conduct’ Test Discharges CERCLA Claims

Because the claim against the debtor was for contribution, Judge Gallagher said that the debtor’s liability would depend on when both the debtor and the settling defendants became liable to the government. In turn, the discharge of the CERCLA claims would depend on when the claims “arose.”

Two policies were at odds, Judge Gallagher said. Bankruptcy aims to give the debtor a “fresh start,” while CERCLA “casts a broad net” of liability to clean up hazardous waste.

Circuits have taken different approaches in deciding whether bankruptcy discharges a CERCLA claim.

Sporting a narrow interpretation of a “claim,” the “right to payment” approach “prioritizes” CERCLA, Judge Gallagher said, and is “the least deferential” to bankruptcy law.

In the Third Circuit, the right-to-payment approach discharges environmental liability only if all four CERCLA elements existed before bankruptcy. One of the elements had not been met because the debtor had not been identified as a PRP before bankruptcy.

The debtor’s liability would not have been discharged if the right-to-payment standard applied. However, Judge Gallagher said that the “right to payment approach has come under criticism for subjugating bankruptcy law and, thus, undermining the goals of bankruptcy.”

Although not in CERCLA cases, Judge Gallagher said that the Fourth Circuit employs the “underlying acts” or “conduct” approach, which says that a claim exists if the underlying acts occurred before bankruptcy, citing *Grady v. A.H. Robins Co., Inc.*, 839 F.2d 198 (4th Cir. 1988), and *Holcombe v. US Airways, Inc.*, 369 F. Appx. 424 (4th Cir. 2010).

Judge Gallagher said that the “underlying acts” standard “respects the intent of the Bankruptcy Code,” which defines “claim” more broadly than the traditional cause of action, no matter how distant or contingent. She acknowledged that the test “has been criticized for undermining CERCLA’s goal of polluter accountability, which would be rendered ineffectual if polluters could evade response costs and action obligations by filing for bankruptcy before EPA became aware of their polluting.”

Judge Gallagher saw herself bound by Fourth Circuit precedent to apply the “more debtor-friendly ‘underlying acts’ or ‘conduct’ approach.” She granted the motion for summary judgment and dismissed the suit because the debts had been discharged since the underlying acts took place before bankruptcy.

A Third Approach

In a footnote at the end of the opinion, Judge Gallagher mentioned that some courts “in recent years” employed a third approach known as the “fair contemplation” test. She said it “attempts to strike a middle ground between the competing objectives of CERCLA and the Bankruptcy Code by” having claims arise when all future response costs resulting from prepetition conduct can be fairly contemplated.

Whatever the merits of the third standard, Judge Gallagher said it “contravenes existing Fourth Circuit precedent in the bankruptcy context.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/69th+street.pdf) *68th Street Site Work Group v. Airgas Inc.*, 20-3385 (D. Md. Oct. 12, 2021).

#### The appeals court barred the holder of a personal guarantee from launching a collateral attack on a confirmed chapter 11 plan.

# Reducing a Personal Guarantee Under a Plan Isn’t a Discharge, Fifth Circuit Says

Although the Fifth Circuit is among the most restrictive courts of appeals when it comes to non-debtor, third-party releases, the New Orleans-based court once again held that a chapter 11 plan can reduce the amount of a non-debtor guarantor’s liability to a creditor.

A couple owned a corporation that operated a grocery store. The couple owned the real estate occupied by the grocery store. The store borrowed $325,000. The couple personally guaranteed the debt and secured the debt with a mortgage on the store and a mortgage on their home.

The grocery store filed a chapter 11 petition and confirmed a plan that called for surrendering the store and its contents to the lender in return for a $225,000 reduction in the couple’s debt on their personal guarantee. The lender had an unsecured claim for the $100,000 deficiency.

After confirmation, the lender evidently decided that the store was not worth $225,000. The lender apparently believed it would have a larger recovery by asserting a claim against the couple for the entire $325,000.

So, the lender began foreclosure proceedings against the couple’s home. The couple filed their own chapter 11 petition in response.

Overruling the lender’s objection, the bankruptcy court confirmed the couple’s chapter 11 plan and held that their debt to the lender had been reduced to $100,000. The district court affirmed, ruling that the lender could not relitigate the debt that had been reduced to $100,000 in the grocery store’s confirmed chapter 11 plan.

Circuit Judge Gregg Costa affirmed once again in an opinion on November 12.

According to Judge Costa, the grocery store’s plan lifted the automatic stay by allowing the lender to foreclose. He found no provision in the plan conditioning the reduction in the guarantee on the lender’s taking title to the store, either by foreclosure or voluntary transfer.

Judge Costa said that the lender could not “upend the arrangement by ignoring the [store’s] obligation and going after the [couple] for the entire debt.”

Even so, the lender argued in the circuit court that Section 524(e) barred the couple from using the grocery store’s plan to reduce their obligations on the guarantee. The section provides that the “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.”

Citing two earlier decisions by the Fifth Circuit, Judge Costa responded by saying:

But discharge is not the issue here. The [grocery store’s] bankruptcy plan does not discharge the [debt to the lender] or the [the couple’s] obligations under it . . . . [A] partial release of liability for the secured portion of the debt is not a discharge.

To understand the principle, Judge Costa said, “imagine that the bankruptcy court had ordered the [grocery store] to turn over cash instead of real estate.” If the lender had received cash, he said, “No one would view an order requiring the [the grocery store’s] estate to pay [the lender] $250,000 in cash as eliminating a guaranty.”

Judge Costa held that a “bankruptcy plan, then, can limit a creditor’s claim against third-party guarantors — not by discharging the guaranty but by determining the source and value of payments satisfying the guaranteed debt.”

Judge Costa buttressed his conclusion by alluding to the preclusive effect of the grocery store’s chapter 11 plan under Section 1141(a), which says that “the provisions of a confirmed plan bind the debtor . . . and any creditor . . . whether or not . . . such creditor . . . has accepted the plan.”

Judge Costa quoted the *Collier* treatise, which says Section 1141(a), like *res judicata*, “precludes parties from raising claims or issues that they could have or should have raised before confirmation.” 8 *Collier on Bankruptcy* § 1141.02 (16th ed. 2021).

Had there been a post-confirmation default by the grocery store under its plan, Judge Costa said that the default “would not void the credit but would instead give rise to a new and separate claim against the [the grocery store] for noncompliance with the plan.”

Judge Costa upheld the judgment, calling the lender’s theory “a collateral attack on the [grocery store’s] bankruptcy plan’s disposition of the secured debt.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/New+Falls.pdf) *New Falls Corp. v. LaHaye (In re LaHaye)*, 19-30795 (5th Cir. Nov. 12, 2021).

#### The Eleventh Circuit has two standards for non-debtor releases: One for free-standing settlements and another for releases engrafted into chapter 11 reorganization plans.

# Eleventh Circuit Differentiates the Two Standards for Approval of Non-Debtor Releases

The Eleventh Circuit has two standards for approval of non-debtor, third-party releases. In a nonprecedential opinion on November 5, the appeals court explained why one applies to chapter 11 reorganizations and the other to settlements.

One company acquired another. After the acquisition, the buyer discovered that officers of the seller had misappropriated about $2 million. Both companies later ended up in chapter 11 with a creditors’ committee.

The two companies, the committee and the defendants worked out a settlement, which included a bar order, as the appeals court called it. The bar order prevented anyone from suing the defendants.

The buyer’s dominant shareholder unsuccessfully objected to the settlement and appealed. The district court affirmed. In the Eleventh Circuit, the shareholder contended that the bankruptcy court had applied the wrong standard for imposing a bar order.

Twenty years apart, the Eleventh Circuit wrote two opinions laying out standards for approval of bar orders. *See* *In re Munford*, 97 F.3d 449 (11th Cir. 1996); and *In re Seaside Engineering & Surveying, Inc.*, 780 F.3d 1070 (11th Cir. 2015). In both cases, the corporate debtors were in chapter 11.

In *Munford*, the bankruptcy court approved a bar order included in settlement of an adversary proceeding. The November 5 *per curiam* opinion explained how the panel in *Munford* approved the bar order as “necessary because at least one of the [defendants] ‘would not have entered into the settlement agreement’ without it, and as such, it was ‘integral’ to the settlement.” *Munford, supra*, 97 F.3d at 455.

In *Seaside*, the debtor proposed a chapter 11 plan to reorganize and continue operating. The plan included a bar order precluding lawsuits against company officers “related to or arising out of the bankruptcy.”

The panel in the November 5 opinion said that *Seaside* approved the bar order “because it was deemed necessary for the reorganized entity to succeed.” *Seaside, supra*, 780 F.3d. at 1077. The panel in 2015 said that failing to prevent “claims against non-debtors . . . would undermine the operations of, and doom the possibility of success for, the reorganized entity.” *Id*.

The November 5 opinion said that *Munford* and *Seaside* presented “non-comparable bar orders.” The fact that they both arose in chapter 11 cases was “non-determinative.” To decide which precedent to apply, the court must review the “context and facts underlying the bar order.”

*Munford*, the circuit said, applies “to bar orders assessed in the settlement context.” They are “appropriate where the parties would not have entered into a settlement agreement without it, and thus it is ‘integral’ to the settlement.”

*Seaside* is applicable “to bar orders that are specifically within the reorganization context” and are proper in “unusual cases in which such an order is necessary for the success of the reorganization.” *Seaside, supra*, 780 F.3d at 1078–1079.

The panel decided that the case on appeal was “more like *Munford*” because “the Bar Order under review was integral to settlement.” The appeals court said that the bar order was not intended “to ensure success for a reorganized entity by eliminating liability,” because neither corporate debtor “sought to reorganize and continue operations.”

Instead, the bar order was adopted “to facilitate a settlement agreement.”

The circuit affirmed because the bankruptcy court had not abused its discretion in applying the *Munford* factors.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Markland.pdf) *Markland v. Davis (In re Centro Group LLC)*, 21-11364 (11th Cir. Nov. 5, 2021).

#### Although averse to third-party releases in chapter 11 plans, the Fifth Circuit will allow bankruptcy courts to enforce releases given by one third party to another.

# Consent Orders Strictly Enforced in the Fifth Circuit, Even if the Result Is Unreasonable

The Fifth Circuit teaches us to beware of negotiated consent orders. Without regard to the intent of the parties, a consent order will be interpreted strictly according to its terms, just like a contract, even if it produces an arguably “unreasonable result.”

The appeals court’s February 9 opinion also attests to the power of a bankruptcy court over noncore matters when the parties consented.

The Broadly Worded Consent Order

A creditor was a party to a contract with the debtor. Before bankruptcy, the creditor and the debtor were asserting claims against one another in state court. The debtor filed a chapter 11 petition, halting the suit in state court.

In bankruptcy, the debtor sold its assets to the secured lender, including the debtor’s claims against the creditor in state court. To some extent, both the lender and the creditor wanted the suit to proceed in state court. Entered by the bankruptcy court, a consent order negotiated among the parties modified the automatic stay and provided the following:

* In state court, the creditor could liquidate its claims against the debtor for the purpose of exercising its rights of setoff and recoupment;
* If the creditor were to obtain a judgment in excess of the debtor’s claims, the excess could only be enforced by a proof of claim in the bankruptcy case; and
* The creditor could recover “*no money damages*” *from the lender* “*under any circumstances* on account of any claims that have been or could have been asserted in” state court. [Emphasis added.]

With the benefit of hindsight, the creditor came to realize that the italicized language in the agreed order was too broad. Here’s why:

In discovery in state court, the creditor learned that the lender allegedly directed the debtor to breach the contract with the creditor. The creditor then sought leave from the state court to assert new claims against both the debtor and the lender.

Trumpeting the agreed order, the lender moved in bankruptcy court to bar the creditor from asserting any direct claims against the lender. Bankruptcy Judge Harlan D. Hale of Dallas sided with the lender and interpreted the agreed order as barring the creditor from asserting any claims in state court against the lender.

Later, the creditor filed a motion in bankruptcy court under Rules 60(b)(4) and (b)(6), contending that the bankruptcy court lacked jurisdiction to enter an order barring one nondebtor (the creditor) from suing another nondebtor (the lender). Bankruptcy Judge Hale found that he had jurisdiction and denied the motion for reconsideration because the language in the lift-stay order had been negotiated among the parties.

The district court affirmed, prompting the creditor to appeal unsuccessfully to the circuit court.

The Bankruptcy Court’s Jurisdiction

In his February 9 opinion, Circuit Judge Patrick E. Higginbotham first addressed the jurisdiction and power of the bankruptcy court to enjoin one nondebtor from suing another nondebtor. Odds would have seemed to favor reversal, because the Fifth Circuit is one of three circuits commonly understood as prohibiting nonconsensual, third-party releases in chapter 11 plans. *See* *Bank of N.Y. Trust Co. v. Official Unsecured Creditors’ Comm. (In re Pacific Lumber Co.),* 584 F.3d 229 (5th Cir. 2009).

Making no analogy to chapter 11, Judge Higginbotham did not depart from established law closer to home. He quickly concluded that a claim by the creditor against the lender could “conceivably” affect the bankruptcy estate, thus conferring “related to” jurisdiction.

Even given jurisdiction, the constitutional power of the bankruptcy court was another question, because the claims by one nondebtor against another were noncore.

Without hesitation, Judge Higginbotham concluded that the lender and the creditor had “knowingly and voluntarily consented to the bankruptcy court’s jurisdiction over the claims in the California Action.” He said,

The parties agreed to the language of the [consent order] and presented it to the bankruptcy court, which then entered the proposed order. The parties having thus consented, the bankruptcy court had jurisdiction to hear and enter appropriate orders related to the proceedings surrounding the entry of the Lift Stay Order.

With jurisdiction and constitutional power to enter the consent order, Judge Higginbotham said that the bankruptcy court “retained jurisdiction to interpret and enforce its orders.”

Interpreting a Consent Order

Referring to the motion for rehearing that the bankruptcy court denied, the creditor argued that the court ignored the parties’ intent and “surrounding circumstances” to “produce an unreasonable result.”

Given that the consent order was negotiated and drafted by the parties, Judge Higginbotham approached interpretation as matter of contract law. He said,

Where a contract’s terms are unambiguous, it must be enforced irrespective of the parties’ subjective intent; the same applies to an unambiguous court order such as the [consent order].

Judge Higginbotham said that the consent order “unambiguously conditioned” stay modification by ordering that the creditor could obtain “no money damages . . . of any kind” from the lender. Reliance on “subjective intent” was “unavailing,” and references to the circumstances were “also irrelevant when interpreting an unambiguous consent order.”

The lesson to be learned: Be careful when negotiating consent orders. They will be interpreted strictly in accordance with the plain language.

[The opinion is](https://abi-opinions.s3.amazonaws.com/PFO.pdf) *VSP Labs Inc. v. Hillair Capital Investments LP (In re PFO Global Inc.)*, 20-10885 (5th Cir. Feb. 9, 2022).

#### Over a dissent, the Eleventh Circuit held that a 1995 chapter 11 plan discharged the liability of ‘related persons’ to pay health care benefits when a coal producer defaulted on the obligation in 2016.

# Circuits Possibly Split on Bankruptcy as Discharging Coal Act Liability for Health Benefits

The Eleventh Circuit wrote a highly complex opinion describing when liabilities that seemingly arose recently were actually discharged in bankruptcy decades earlier.

The majority’s holding comes down to this: Affiliates of a coal producer discharged their joint liabilities under the Coal Act to pay health care benefits for miners by having emerged from chapter 11 in 1995, even though the coal miner itself only stopped paying the benefits in 2016.

In other words, according to the majority, the claims against the affiliates for payments toward health care benefits had been discharged in 1995, although the obligation for the affiliates to make the payments only arose in 2016.

The majority opinion and the dissent combine to represent an obtuse exposition of the competing concepts pinpointing the time when a claim arises and is discharged.

The Coal Act Claims

Coal producers were going out of business right and left, depriving coal miners of their health care benefits. In 1992, Congress enacted the Coal Act, which made “related persons” jointly and severally liable for health care benefits no longer being paid by a coal producer.

In 1989, a coal producer and its affiliates went into chapter 11. They all confirmed a plan in 1995. Under the plan, the coal producer alone shouldered ongoing responsibility for providing health care. The affiliates split off from the coal producer several years after confirmation.

There was no dispute that the affiliates were “related persons” theoretically liable for health care benefits once the coal producer stopped paying for them.

The coal producer filed a second bankruptcy in 2015 and stopped paying for health care benefits in 2016. Aiming to compel the former affiliates to pay the benefits, the fund established by the Coal Act to pay benefits sued the affiliates in district court in Washington, D.C.

The affiliates responded by reopening their 1989 bankruptcies and arguing that their liabilities under the Coal Act had been discharged by the plan in 1995. Affirmed in district court, the bankruptcy court granted summary judgment for the fund by ruling that the claims had not been discharged.

The Majority Opinion

In a 26-page opinion for the majority, Circuit Judge William Pryor reversed, ruling that the claims against the affiliates had been discharged in 1995.

To Judge Prior’s way of thinking, the outcome of the appeal depended on whether there was a claim against the affiliates in 1995. If there was a claim in 1995, then it was discharged, he reasoned.

Judge Pryor began from the proposition that the definition of a claim in Section 101(5) is given the broadest meaning. He said that the discharge of the affiliates’ liability on a claim based on their conduct before confirmation depended on whether there had been a relationship between the affiliates and the fund before confirmation.

Simply put (but explained in detail in later pages), Judge Pryor said that the fund

held “claims” for future [benefits] in 1995 because their right to payment was based on the [affiliates’] pre-confirmation conduct. In 1995, the [affiliates’] liability to the retirees had already been fixed; only the amount owed was uncertain.

The amount of the eventual claim in 1995 was “uncertain,” Judge Pryor said, but the uncertain amount only meant that the claim was contingent, and contingent claims are discharged.

The opinion by Judge Pryor may represent a split with the Second Circuit in *LTV Corp. v. Shalala (In re Chateaugay II)*, 53 F.3d 478 (2d Cir. 1995). There, he said, the New York-based appeals court held that post-confirmation liability under the Coal Act was not dischargeable.

Judge Pryor found the Second Circuit’s opinion “unpersuasive” because “our sister circuit failed to provide any rationale for its holding.” He read the Second Circuit as saying that premiums under the Coal Act were nondischargeable taxes.

Even if the liabilities were taxes, Judge Pryor said, the affiliates’ liability would rest entirely on their pre-bankruptcy conduct and would be discharged. He said that *Chateaugay II* “has no bearing on when claims for those premiums arise.”

Judge Pryor reversed and remanded.

The Dissent

Circuit Judge R. Lanier Anderson, III dissented in a 15-page opinion. He said that the obligation to fund an individual employer plan under Section 101(5)(B) or a so-called 1992 Plan premium did not arise until 2016 and was not discharged in 1995.

Judge Anderson latched on to Section 101(5)(B). The subsection, he said, means there is a claim only if an equitable remedy gives rise to a right to payment.

“Before there is a ‘breach of performance’ by the debtor,” Judge Anderson said, “the creditor can have no ‘right to an equitable remedy.’” Since the relevant breach occurred in 2016, “the claim arising out of that breach cannot have been discharged in 1995.”

Judge Anderson saw the majority’s opinion as being “in tension with the established law that a bankruptcy confirmation plan does not discharge claims that arise on account of post-confirmation conduct of the debtor.”

Judge Anderson “respectfully” dissented because, in his view, the “breach occurred in 2016, [and the affiliates’] 1995 bankruptcy confirmation could not discharge the . . . claim arising from it.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/US+Pipe+%26+Foundry.pdf) *U.S. Pipe & Foundry Co. v. Holland (In re U.S. Pipe & Foundry Co.)*, 20-13832 (11th Cir. May 3, 2022).

#### Reversing the bankruptcy court, a district judge in New York held that a civil penalty wasn’t discharged even though the fraud wasn’t committed against the government.

# Civil Penalties for Defrauding Consumers Weren’t Discharged

Reversing the bankruptcy court while expounding and expanding on the Supreme Court’s *Cohen* decision, District Judge Paul A. Engelmayer of New York ruled that a civil penalty imposed by the Federal Communications Commission for defrauding consumers is not discharged in a corporate debtor’s chapter 11 case under Section 1141(d)(6)(A).

In *Cohen v. de la Cruz*, 523 U.S. 213 (1998), the Supreme Court held that treble damages and attorneys’ fees imposed against a bankrupt landlord in favor of tenants under state law for actual fraud in charging excess rent were not dischargeable under Section 523(a)(2)(A), even though the treble damages were in excess of the actual damages sustained by the tenants.

The case before Judge Engelmayer was different from *Cohen* in that the government had not been defrauded, whereas the tenants in *Cohen* had been.

The Defrauded Customers and the Government Fine

The debtor was a telecommunications provider that entered into a consent decree with the Federal Communications Commission before bankruptcy. The debtor had made misrepresentations to consumers in marketing calls and placed unauthorized charges on customers’ bills.

The consent decree called for the debtor to issue $1.9 million in refunds to customers and pay a $4.2 million civil penalty to the FCC over five years. By the time the debtor filed in chapter 11, the debtor had paid its customers, but not $2.1 million of the fine to the FCC.

The government filed an adversary proceeding to declare that the $2.1 million remaining to be paid on the civil fine was not dischargeable under Section 1141(d)(6)(A). The bankruptcy judge ruled that the remaining fine was dischargeable. *U.S. v. Fusion Connect Inc. (In re Fusion Connect Inc.)*, 617 B.R. 36 (Bankr. S.D.N.Y. June 9, 2020). To read ABI’s report, [click here](about:blank).

The government appealed and won in a September 2 opinion by Judge Engelmayer.

The Controlling Statutes

Two statutes were controlling: Sections 523(a)(2)(A) and 1141(d)(6)(A).

Section 523(a)(2)(A) bars discharge of a debt “obtained by . . . false pretenses, a false representation, or actual fraud,” but it applies only to individual debtors.

To prevent corporate debtors from filing in chapter 11 to discharge debts owing to the government for fraud, the so-called BAPCPA amendments in 2005 added Section 1141(d)(6)(A). Now, confirmation in chapter 11 does not discharge a corporate debtor from “any debt . . . of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to a domestic governmental unit . . . .”

The debtor had several arguments to say that the fine was dischargeable: No fraud was committed against the government; the debtor made no misrepresentations to the government; the victims of the fraud had been made whole; and the fine would not fall under the definition of a common law fraud.

Judge Engelmayer knocked down the arguments in his 27-page opinion.

*Cohen* Controls

Like the bankruptcy court, Judge Engelmayer began with *Cohen*, but unlike the bankruptcy court, he didn’t go much further.

He addressed two questions: Was the fine a “debt,” and was it “obtained by” fraud?

Judge Engelmayer said that “*Cohen* underscored the breadth of the debts that Section 523(a)(2)(A) exempts from discharge.” Regarding whether the treble damages were a “debt,” he quoted the Supreme Court for saying that treble damages and attorneys’ fees “fell within the scope of ‘any debt’” for money or property that was fraudulently obtained. *Cohen*, *supra*, 523 U.S. at 218.

*Cohen* also held that the treble damages and attorneys’ fees were “obtained by” fraud.

To define the broad scope of Section 523(a)(2)(A), Judge Engelmayer quoted the Supreme Court for saying that the section “prevents the discharge of all liability arising from fraud.” *Id*. at 215.

To plug a hole, Congress adopted Section 1141(d)(6)(A) seven years after *Cohen*. He said that Cohen’s “broad” construction of Section 523(a)(2)(A) “necessarily governs the construction of Section 1141(d)(6)(A).”

Focusing on Section 1141(d)(6)(A), Judge Engelmayer noted that *Cohen* involved non-compensatory treble damages and attorneys’ fees, while the appeal before him entailed non-compensatory civil penalties imposed by a governmental unit that was not a victim of fraud.

Following the direction shown by *Cohen*, Judge Engelmayer easily concluded that the civil fine was a debt resulting from money “obtained by fraud.” In that regard, he cited *Cohen* for saying that the debt itself need not be obtained by fraud, so long as it was traceable to fraud. *Id*. at 218-221.

Non-Statutory Arguments Fail

The debtor contended that the fine should be dischargeable because it did not contain the common law elements of fraud.

Judge Engelmayer countered by saying that the customers suffered from “actual fraud.”

Next, the debtor argued that the fraud was not directed against the government.

“Neither the statutory text nor the case law construing Section 523(a)(2)(A), however, requires that the common law elements of fraud must be met both as to the fraud and as to the creditor holding a debt arising from the fraud,” Judge Engelmayer said. He cited two bankruptcy courts for holding that judgments in favor of the government were nondischargeable when the common law elements of fraud were shown in fraud foisted on consumers.

To buttress his conclusion, Judge Engelmayer cited the Third and Eleventh Circuits for holding that disgorgement judgments obtained by the Securities and Exchange Commission were not discharged, although the fraud had not been directed against the SEC.

The debtor argued that dischargeability should be judged by Section 523(a)(7), which bars an individual from discharging fines and penalties assessed by the government that are not compensation for actual pecuniary loss. Since it was not an individual, the debtor contended that the debt should be discharged.

Judge Engelmayer disagreed. Some overlap happens in statutes, he said

Finally, Judge Engelmayer said that the debtor’s policy arguments were “unusually unpersuasive.” Allowing a corporate debtor “to shed a regulatory fraud penalty in this manner could invite mischief.” He reversed and remanded.

[The opinion is](about:blank) *U.S. v. Fusion Connect Inc. (In re Fusion Connect Inc.)*, 20-5798, 2021 BL 333387 (S.D.N.Y. Sept. 2, 2021).

### Stays & Injunctions

#### Reliance on advice of counsel is not a complete defense to contempt citations.

# Fourth Circuit Rules Emphatically that *Taggart* Applies to All Contempt in Bankruptcy

The Fourth Circuit has ruled emphatically that *Taggart* applies to all contempt citations in bankruptcy court.

However, the Richmond, Va.-based appeals court held that advice of counsel is not a complete defense to civil contempt in bankruptcy court.

A couple filed a chapter 11 petition after falling $23,000 behind on their mortgage. The bankruptcy court confirmed the plan without modifying the plan to specify how future mortgage payments would be applied to principal, interest and arrears.

The plan and confirmation order were vague in other respects. The papers (1) did not state how much the debtors would owe on confirmation; (2) did not say how the $23,000 in arrears would be paid, if at all; (3) set the first day for payment but did not say how much the payment would be; and (4) said that the original loan terms would remain in effect, except as modified.

The servicer did not appeal confirmation.

The debtors made monthly payments. For five years after confirmation, the lender treated the loan as being in default. After the debtors objected and claimed that their mortgage should be treated as current, the servicer conferred with counsel a dozen times. Counsel told the servicer that the loan was correctly listed as being in default.

The servicer eventually listed the property for foreclosure. After further complaints from the debtors, the servicer withdrew the foreclosure and treated the loan as being current.

The debtors then brought proceedings in bankruptcy court to impose civil contempt sanctions. Ultimately, the bankruptcy court imposed monetary sanctions of almost $115,000, including lost wages, attorneys’ fees and “loss of fresh start.”

The servicer appealed and won a reversal in district court last July. *See* *Newrez LLC v. Beckhart*, 20-192, 2021 BL 294572, 2021 US Dist Lexis 146230, 2021 WL 3361707 (E.D.N.C. July 2, 2021). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/nc-appellate-court-rules-plans-must-be-unambiguous-to-hold-a-creditor-in-civil).

The district court evaluated the servicer’s contempt liability by the standard in *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), where the Supreme Court held that there can be no sanctions for civil contempt of a discharge injunction if there was an “objectively reasonable basis for concluding that the creditor’s conduct might be lawful under the discharge order.” *Id*. at 1801. To read ABI’s discussion of *Taggart*, [click here](about:blank).

The district judge went on to say that he was “not convinced . . . that the discharge order . . . in *Taggart* is different from the confirmation order at issue here.” Applying *Taggart*, the district judge decided that the servicer had acted in good faith and “adopted a reading that seemed consistent with the contractual terms of the loan and was objectively reasonable.”

The district judge reversed and remanded for further proceedings because “the bankruptcy court’s contempt order falls far short of the standard required for a finding of civil contempt.” The district court also noted that the servicer had acted several times on advice of counsel.

The debtors appealed to the circuit.

*Taggart* Applies

The debtors argued in the circuit that *Taggart* only applies to alleged discharge violations. Circuit Judge Toby J. Heytens rejected this contention in his April 15 opinion. He said that “*Taggart* applies broadly and cannot be confined to Chapter 7 bankruptcy in the way the [debtors] seek.”

Judge Heytens said,

Nothing about the Supreme Court’s analysis in *Taggart* suggests it is limited to violations of Chapter 7 discharge orders — which liquidate a debtor’s assets and then discharge the debt — or that the Court’s decision turned on considerations unique to the Chapter 7 context.

Judge Heytens held “that the standard articulated by the Supreme Court in *Taggart* governs civil contempt under Chapter 11 of the Bankruptcy Code as well.” Although chapter 11 may differ from chapter 7, he said that “a bankruptcy court’s authority to enforce its own orders — regardless of which chapter of the Bankruptcy Code those orders were issued under — derives from the same statutes and the same general principles the Supreme Court relied on in *Taggart*.”

But Judge Heytens was not prepared to affirm. He found fault with one important aspect of the district court’s opinion: He said that “the district court erred in appearing to grant controlling weight to the fact that [the servicer] had requested and received legal advice from outside counsel.”

Judge Heytens cited the Fourth Circuit for holding before *Taggart* that advice of counsel is not a defense in civil contempt. Consequently, he held that “the district court erred when concluding that [the servicer’s] reliance on the advice of outside counsel was seemingly dispositive as a defense to civil contempt.”

Although advice of counsel is not a complete defense, Judge Heytens added in a footnote that it “may still be considered in appropriate circumstances as a relevant factor under the *Taggart* standard.” More particularly, he said that “a party’s reliance on guidance from outside counsel may be instructive, at least in part, when determining whether that party’s belief that she was complying with the order was objectively unreasonable.”

Having found error in the decisions by both the bankruptcy and district courts, Judge Heytens reversed and remanded to the bankruptcy court “as the court of first instance and the tribunal closest to the facts.” He gave instructions to “reconsider the contempt motion under the correct legal standard, including any additional factfinding that may be necessary.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/beckhart.pdf) *Bechkart v. Newrez LLC*, 21-1838 (4th Cir. April 15, 2022).

#### Even for egregious, repeated violations of Bankruptcy Rule 3002.1, the bankruptcy court may only award recovery of economic losses, never punitive damages.

# Second Circuit Makes *Taggart* Applicable to All Contempt Citations in Bankruptcy Court

Over a vigorous dissent, the Second Circuit overruled the bankruptcy court and in the process made two landmark rulings: (1) The *Taggart* standard for the imposition of contempt applies to all proceedings in bankruptcy court, not only for violating the discharge injunction; and (2) bankruptcy courts may not impose contempt sanctions for violations of Bankruptcy Rule 3002.1, which requires lenders to give notice within 180 days of fees or expenses being charged against a debtor.

According to the majority, sanctions even for repeated violations of Rule 3002.1 are limited to economic damages, which may be minimal.

The dissent concurred with the broad imposition of the *Taggart* standard but argued that contempt sanctions should be available under Rule 3002.1 or the bankruptcy court’s inherent powers.

Perhaps accurately, the dissenter said that the majority rendered “a bankruptcy court powerless to levy any sanction under the Rule [3002.1] against a serial violator of the Rule’s provisions over a substantial period of time where those violations . . . did not result in any actual economic harm to the multiple debtors who were the victims of the Rule violations.”

The Repeated, Flagrant Violations of Rule 3002.1

Bankruptcy Rule 3002.1 was added in 2011 to avoid situations where chapter 13 debtors would have received a discharge but face foreclosure on account of undisclosed post-petition charges from mortgage lenders.

In his majority opinion on August 2, Circuit Judge Dennis Jacobs said the rule was also designed to aid mortgage servicers in fear of allegedly violating the automatic stay by notifying chapter 13 debtors about defaults on mortgages.

Rule 3002.1(c) requires mortgage lenders to file notices of post-petition fees and charges within 180 days of when the charges were incurred.

For failure to file a notice, Rule 3002.1(i) allows the bankruptcy court to disallow the charges and “award *other appropriate relief, including* reasonable expenses and attorneys’ fees caused by the failure.” [Emphasis added.]

The opinion by the bankruptcy judge involved three debtors and a company advertising itself as one of the country’s 10 largest mortgage originators and servicers.

The servicer had been in trouble before for violating Rule 3002.1. The bankruptcy judge said that the servicer had been “chastised” by a bankruptcy judge in North Carolina for violating the rule. In one of the three cases in her court, the bankruptcy judge said that the servicer previously agreed to pay a $9,000 sanction for sending erroneous mortgage statements for three years.

In two of the three cases, the bankruptcy court had previously entered an order declaring that the debtors were current on all pre- and post-filing payments, fees and charges. Within a month after the so-called Debtor Current Orders, the servicer began billing the debtors for about $250 in fees allegedly incurred during the periods encompassed by the Debtor Current Orders. In those two cases, the servicer had not filed notices required by Rule 3002.1(c).

In the third case, there was no Debtor Current Order, but the servicer billed for expenses without filing the Rule 3002.1(c) notice.

For violating the rule, the bankruptcy judge imposed a total of $75,000 in sanctions under Rule 3002.1(i), representing $1,000 for each of the 25 months in which the servicer billed the three debtors without filing a notice.

In one of the cases where there was a Debtor Current Order, the bankruptcy judge imposed $100,000 in sanctions under Section 105. In the case with a Debtor Current Order where the lender had previously paid a $9,000 sanction for improper billing, she assessed a $200,000 sanction.

The bankruptcy court imposed Section 105 sanctions because she said that the record “categorically demonstrates” that the $9,000 sanction two years earlier had failed to achieve its intended remedial effect of deterring the servicer from sending out “inaccurate account statements.” Since she had given the servicer “an opportunity to bring its practices in line with the mandates of Rule 3002.1,” the bankruptcy judge felt that “the time has come for ‘the imposition of severe sanctions.’”

The bankruptcy judge admitted that the sanctions were not in the nature of coercive civil contempt sanctions because the servicer already had waived the post-filing fees. She based her action on the court’s “inherent authority” under Section 105 to impose punitive, non-contempt sanctions even when there had been belated compliance.

The sanctions totaled $375,000 and were to be paid to the state’s largest *pro bono* provider of legal services in bankruptcy cases. *In re Gravel*, 556 B.R. 561 (Bankr. D. Vt. Sept. 12, 2016). To read ABI’s report on the first bankruptcy court opinion, [click here](https://www.abi.org/newsroom/daily-wire/mortgage-servicer-saddled-with-375000-in-sanctions-for-violating-rule-30021).

The servicer appealed. The district court reversed, ruling that $375,000 in sanctions exceeded the bankruptcy court’s statutory and inherent powers. Remanding, the district court said that the bankruptcy court could enforce its orders short of punitive sanctions.

After remand, the bankruptcy court adopted its previous findings and imposed the same $75,000 in sanctions for violating Rule 3001.2. The bankruptcy court reduced the other $300,000 in sanctions to $225,000. *In re Gravel*, 601 B.R. 873 (Bankr. D. Vt. June 27, 2019).

The servicer appealed. The Second Circuit accepted a direct appeal, overstepping an intermediate appeal to the district court.

Sanctions for the Debtor Current Orders

In his 33-page opinion, Judge Jacobs first reviewed the $225,000 in contempt sanctions for violation of the Debtor Current Orders.

Those orders declared that the debtors were current on their mortgages, including all monthly payments and any other charges. The orders prohibited the servicer “from disputing that the debtors are current (as set forth herein) in any other proceeding.”

Simply put, Judge Jacobs said that the servicer “did not, as a matter of law, violate” the Debtor Current Orders. The orders, he said, “did not enjoin the recording of expired fees on the statements” sent to the debtors.

Judge Jacobs applied the contempt standard established in *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), where the Supreme Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an “objectively reasonable basis for concluding that the creditor’s conduct might be lawful under the discharge order.” *Id*. at 1801. To read ABI’s discussion of *Taggart*, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-rejects-strict-liability-for-discharge-violations).

Under *Taggart*, Judge Jacobs said there can be contempt for violating an “injunction only ‘if there is *no fair ground of doubt* as to whether the order barred the creditor’s conduct.’” *Id*. at 1799. [Emphasis in original.]

“Without an express injunction” barring the servicer from sending out statements contrary to the Debtor Current Order, Judge Jacobs said there was a “fair ground of doubt as to whether the listed fees can form the basis for contempt.” He said that the bankruptcy court “could have crafted an order that would have forbidden the conduct.”

No Contempt for Violating Rule 3002.1

Judge Jacobs turned to the $75,000 in sanctions for violating Bankruptcy Rule 3002.1 by failing to file required notices.

Judge Jacobs began by noting how the sanctions were based on the number of incorrect mortgage statements, not the amount of incorrect charges that totaled $716. The bankruptcy court found authority for the sanction in Rule 3002.1’s authorization to “award other appropriate relief, including reasonable expenses and attorneys’ fees caused by the failure.”

Evidently minimizing the word “including” but focusing on “expenses and attorneys’ fees,” Judge Jacobs held that “other appropriate relief is limited to “nonpunitive sanctions.” He said that other provisions in the Bankruptcy Code, such as Section 362(k)(1), explicitly authorize punitive sanctions. Similarly, he said that Rule 3002.1 lacks a reference to “just orders,” like analogous Rule 37 of the Federal Rules of Civil procedure.

Given that the sanctions were not permitted by Rule 3002.1, Judge Jacobs deflected the argument that the $75,000 in sanctions were permissible under the court’s inherent powers. The circuit court, he said, could not consider the question because, in his view, the bankruptcy court had not adequately assessed whether the sanctions were authorized under inherent powers.

Judge Jacobs said it was “dubious” whether the bankruptcy court exercise its inherent powers because “there is no finding of bad faith.” In short, he held,

The sanction was imposed under Rule 3002.1(i), and our holding is that the sanction went beyond the relief authorized by that rule.

Despite the holding, Judge Jacobs left the door open for sanctions in future cases when the bankruptcy court uses a few magic words. He said that his opinion “does not limit a bankruptcy court’s inherent power to sanction offenders who act in bad faith. That is just not what the bankruptcy court did here; others might be free to do so if they were to make sufficient findings.”

Judge Jacobs reversed and vacated the bankruptcy court’s order. The majority did not remand and allow the bankruptcy judge to explain whether she had issued sanctions under the court’s inherent powers.

The Dissent

Circuit Judge Joseph F. Bianco wrote a 36-page dissent, three pages longer than the majority’s opinion. However, he agreed with the majority’s holding that the Debtor Current Orders “did not clearly and unambiguously prohibit” the servicer’s conduct. In other words, he appears to agree that *Taggart* applies to all potential contempt findings in bankruptcy court, including violations of the automatic stay.

Although he “respectfully” dissented, Judge Bianco vigorously disagreed with vacating the $75,000 in sanctions for violating Rule 3002.1. He believes that the “‘other appropriate relief’ language in [Rule 3002.1(i)(2)] conferred upon bankruptcy courts . . . a proper basis to impose the $75,000 punitive sanction against [the servicer] based upon its flagrant and repeated violations of the Rule.”

Judge Bianco saw his understanding of the Rule as being “not only consistent with the plain text of the Rule itself but is further supported by the purpose of the Rule and the fact that the Rule was modeled after Rule 37 of the Federal Rules of Civil Procedure, which allows for similar punitive sanctions.”

Even if Rule 3002.1 in itself did not permit the imposition of sanctions, Judge Bianco believes that the bankruptcy court has “independent authority under its inherent powers to impose this $75,000 sanction against [the servicer] for its egregious conduct in violation of the Rule.” The record, he said, was “more than sufficient” for upholding $75,000 in sanctions under a court’s inherent powers.

Judge Bianco went further. He read the “the plain text of Rule 3002.1 [as allowing] punitive, non-compensatory sanctions . . . consistent with the Rule’s purpose.”

On a practical level, Judge Bianco saw reason for punitive sanctions. He said that the “reimbursement of costs to a debtor for a Rule violation . . . does little to prevent future violations and therefore falls far short of safeguarding the Chapter 13 ‘fresh start’ process for all such debtors.”

Judge Bianco also disagreed with the majority failure to remand. He would have allowed the bankruptcy court on remand to expound on its “reasoning for the imposition of sanctions under its inherent powers.”

Observations

When *Taggart* came down, the question arose, “Does the same standard apply to contempt for violation of the automatic stay?”

The Second Circuit has now answered the question. In the Second Circuit, *Taggart* seems to apply not only to automatic stay violations but also to any circumstance when the bankruptcy court is inclined to impose contempt sanctions.

In this writer’s view, applying *Taggart* to automatic stay violations means there can be no contempt if the creditor has a non-frivolous argument aimed at explaining why there was no violation of Section 362.

The majority’s opinion also means that bankruptcy courts (and the lawyers who draft proposed orders) must now lay out in detail the types of actions that are prohibited. Otherwise, contempt will be unavailable.

On Rule 3002.1, the lower courts are split about the availability of contempt. The Second Circuit is the first appeals court to reach the issue. There may be a circuit split eventually.

Fortunately, the Rule could be amended without Congressional action to permit contempt sanctions for violations of Rule 3002.1.

This writer predicts there will be a petition for rehearing *en banc*, but the Second Circuit rarely agrees to sit *en banc*. The vigorous dissent makes a strong case for sitting *en banc*.

The opinion will have wide-ranging effect on bankruptcy. For example, the panel made blanket statements without reflecting on how applying *Taggart* will affect enforcement of the automatic stay.

The circuit should grant rehearing *en banc*, allowing scholars and the wider community to appear as *amici* and comment on what may be the most significant circuit court decision this year on bankruptcy law.

[The opinion is](https://abi-opinions.s3.amazonaws.com/PHH+v+Sensenich.pdf) *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), rehearing and rehearing en banc *den*. Nov. 1, 2021.

#### Lack of authority on point is no defense to a willful violation of the automatic stay, according to the Third Circuit.

# Good Faith Is No Defense to an Allegedly Willful Stay Violation, Third Circuit Says

The Third Circuit handed down an opinion containing several holdings that close the door on defenses a creditor could make after being charged with a willful violation of the automatic stay:

* The Third Circuit’s *University Medical* decision in 1992 did not create a general good faith defense to an automatic stay violation;
* Willfulness and good faith are separate and distinct issues when it comes to automatic stay violations;
* The lack of authority on the precise facts of an alleged stay violation does not create a defense in itself; and
* The appeals court cast doubt on lower courts’ decisions in the Third Circuit finding no stay violation from an educational institution’s refusal to turn over a transcript if the underlying debt to the school is nondischargeable.

Contempt for Withholding a Transcript

When the debtor filed her chapter 13 petition, she owed about $6,000 to a college. After filing, she requested that the college send her a transcript. The college sent a transcript, but it did not show that she had graduated.

When challenged about the accuracy of the transcript, the college said it had put a “financial hold” on a complete transcript because she owed the school $6,000.

The college filed an adversary proceeding seeking a declaration that the debt was a nondischargeable student loan. Counterclaiming, the debtor alleged that withholding an accurate transcript was a willful violation of the automatic stay under Section 362(k).

Later, the college withdrew the nondischargeability claim with prejudice, establishing that the debt was dischargeable.

The bankruptcy court held a trial and ruled that the school had violated the automatic stay by withholding a complete transcript. Finding the violation to be willful, the bankruptcy judge entered judgment in favor of the debtor, awarding about $200 in actual damages plus attorneys’ fees to be determined later. The bankruptcy court denied a request for punitive and emotional distress damages.

The district court affirmed, and so did the Third Circuit in a September 9 opinion by Circuit Judge Julio M. Fuentes.

The Amendment to Section 362(k)

The college conceded that it violated the automatic stay but argued that the violation was not willful. Section 362(k)(1) provides that “an individual injured by any willful violation of a stay provided by this section [362] shall recover actual damages, including costs and attorneys’ fees, and, in appropriate circumstances, may recover punitive damages.”

In large part, the college argued that its actions were not willful under *In re University Medical Center*, 973 F.2d 1065 (3d Cir. 1992). Much of Judge Fuentes’ opinion was spent in explaining what *University Medical* did or did not hold and why it was not legislatively overruled by the amendment of Section 362(k) in 2005.

Before the so-called BAPCPA amendments in 2005, Section 362(k) said nothing about good faith. The amendment added subsection (2), which says:

If such violation is based on an action taken by an entity in the good faith belief that [the stay automatically terminated for the debtor’s failure to file a statement of intention], the recovery under paragraph (1) of this subsection against such entity shall be limited to actual damages.

*University Medical* Wasn’t Legislatively Overruled

The defendant in *University Medical* argued that its actions were not willful, thus providing insulation from damages and attorneys’ fees. At the time the opinion was written in 1992, Section 362(k) did not say whether good faith was a defense. Then, the statute only addressed a “willful violation” of the stay.

However, the Third Circuit had ruled two years before *University Medical* that a defendant’s good faith belief that its actions did not violate the stay did not, by itself, “establish a defense to willfulness,” Judge Fuentes said. *See In re Atlantic Business & Community Corp.*, 901 F.2d 325, 329 (3d Cir. 1990). The appeals court said there was ample evidence that the defendant acted intentionally and with knowledge of the stay, despite the defendant’s claim that its actions were in good faith.

In *University Medical*, Judge Fuentes said, the defendant did more than claim good faith. The defendant presented “persuasive authority” to show that a stay violation was “uncertain.”

According to Judge Fuentes, the Third Circuit held in *University Medical* that good faith by itself was “insufficient” but that “persuasive authority negated any finding of willfulness” and obviated liability for damages.

Several bankruptcy courts concluded that *University Medical* was legislatively overruled because the amendment to Section 362(k) installed a good faith defense that was narrower than the 1992 decision. Judge Fuentes disagreed.

Judge Fuentes agreed with recently retired Bankruptcy Judge S. Martin Teel, Jr., who read *University Medical* to mean that good faith is not a defense to willfulness. Rather, willfulness is separate and distinct from good faith.

Judge Teel explained:

[W]hen the law is sufficiently unsettled, willful violation of the statutory command is absent, and damages are not recoverable, because the offending party has not acted in violation of a command of which it had fair notice.

*In re Stancil*, 487 B.R. 331, 343-44 (Bankr. D.D.C. 2013).

Judge Fuentes cited the First Circuit for also interpreting *University Medical* to mean that a good faith belief that one’s actions do not violate the stay is not determinative of willfulness. *IRS v. Murphy*, 892 F.3d 29, 37-38 (1st Cir. 2018).

Judge Fuentes read *University Medical* as not creating a good faith defense, like the limited good faith defense created in 2005 for situations where there was an automatic termination of the stay for failure to file a statement of intention.

On the bottom line, Judge Fuentes concluded that *University Medical* remains good law. The 1992 opinion, he said, makes a willfulness defense “separate and distinct from one of good faith alone.”

The College Had No Authority on Its Side

Unlike the defendant in *University Medical*, the college-appellant had no “persuasive authority” to support the notion that withholding a transcript did not violate the stay, Judge Fuentes said. The college, he said, “predominantly relies on the absence of case law addressing these precise facts.”

Judge Fuentes held:

[A] lack of case law to the contrary does not render the law sufficiently unsettled under *University Medical*. Rather, the defendant must point to authority that reasonably supports its belief that its actions were in accordance with the stay.

The college cited two bankruptcy court decisions in the Third Circuit for the idea that withholding a transcript is no stay violation. Judge Fuentes distinguished both.

In both cases, the bankruptcy courts found no stay violation for withholding a transcript when the underlying debt to the school was nondischargeable. In the case on appeal, the college had withdrawn its complaint and conceded that the debt was dischargeable.

Judge Fuentes cited three other circuits and “many other federal courts” for holding that withholding a transcript is a stay violation, even when the debt is nondischargeable.

Because the college failed to show that the law was “sufficiently unsettled within the meaning of *University Medical*,” Judge Fuentes upheld the district court for finding a willful stay violation.

There Was Sufficient Injury

The college claimed there was not a sufficiently meaningful injury to justify a stay violation.

The bankruptcy court had awarded the debtor about $200 in lost wages for time spent in court to attend trial. The college, Judge Fuentes said, cited “no authority for its position that a debtor’s lost wages from attending trial, even if a modest amount, is not a legitimate financial harm.” Likewise, he saw no “compelling explanation” for the idea that “attorneys’ fees do not constitute a financial injury on their own.”

Judge Fuentes found other “cognizable injury” under Section 362 arising from the debtor’s failure to receive a complete transcript.

Judge Fuentes affirmed the district court.

Observations

In *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), the Supreme Court rejected a strict liability standard for violation of the discharge injunction. Instead, the Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an “objectively reasonable basis for concluding that the creditor’s conduct might be lawful under the discharge order.” *Id*. at 1801. To read ABI’s discussion of *Taggart*, [click here](about:blank).

In a footnote, Judge Fuentes seemed to say there was no reason to discuss *Taggart* because the court was not imposing a strict liability standard.

Increasingly, courts are saying that *Taggart* also applies to alleged violations of the automatic stay.

This writer submits that *Taggart* was worthy of discussion to determine whether the college in the Third Circuit case had an “objectively reasonable basis” for believing that withholding a transcript was no stay violation.

Did Judge Fuentes satisfy the *Taggart* standard by finding no “persuasive authority” to support the college’s argument? Is no “persuasive authority” equivalent to no “objectively reasonable basis?” Were two distinguishable cases in bankruptcy court sufficient to give the college a defense under *Taggart*?

[The opinion is](about:blank) *California Coast University v. Aleckna (In re Aleckna)*, 20-1309 (3d Cir. Sept. 9, 2021).

#### The BAP decision may have a hint that failure to stop proceedings after bankruptcy can be an automatic stay violation, even after Fulton.

# No Duty to Release an Attachment After *Fulton*, Ninth Circuit BAP Says

Concluding that the Supreme Court’s *Fulton* decision overruled prior Ninth Circuit authority, the Ninth Circuit Bankruptcy Appellate Panel held that a creditor no longer violates any provision of the automatic stay in Section 362(a) by maintaining the *status quo* and declining to vacate a prepetition attachment.

While the decision under Section 362(a)(3) is no surprise given that *Fulton* addressed the same subsection, the November 10 BAP opinion is noteworthy for finding no stay violations under any other subsection in Section 362(a).

The Prepetition Attachment

A municipality in Arizona obtained a $30,000 judgment against an individual and served a writ of garnishment on a bank that held about $9,000 belonging to the judgment debtor in three accounts.

The judgment debtor moved in state court to quash the garnishment, contending that the accounts were community property. The state court allowed the city to take discovery, but the debtor filed a chapter 13 petition before the city took further action in state court.

Once in bankruptcy, the debtor’s counsel sent messages to both the city and bank demanding the release of the attachment. The city’s attorney responded by filing a motion to stay the litigation in state court.

The debtor moved the state court to vacate the garnishment. The city’s attorney responded by saying that the city would abide by whatever decision was made under the Bankruptcy Code and did not oppose releasing the funds.

More specifically, the city told the debtor that Section 362(a) only required staying the proceedings, not dismissing the garnishment.

The state court vacated the garnishment, and the bank released the funds. The debtor then filed a motion in bankruptcy court seeking $30,000 in damages for a willful violation of the stay under Section 362(k).

The Pre-*Fulton* Finding of a Stay Violation

At the ensuing hearing held before the Supreme Court handed down *Fulton*, the bankruptcy court cited Ninth Circuit authority from 2017, faulted the city for not vacating the garnishment, and entered an order finding a stay violation. The bankruptcy court told the debtor to proceed with a hearing to fix damages.

After *Fulton* came down, the city filed a motion for rehearing under Bankruptcy Rule 9024 and Federal Rule 60(b). The bankruptcy court granted rehearing.

The Ruling After *Fulton*

Ruling under *Fulton*, the bankruptcy court said that its prior ruling was wrong and that the automatic stay does not require a creditor to take affirmative action under any of the subsections in Section 362(a).

The debtor appealed to the BAP, but Bankruptcy Judge Robert J. Faris affirmed for the BAP in an opinion on November 10.

First, Judge Faris dealt with the question of whether the city properly moved for rehearing under Bankruptcy Rule 9024. He said that the finding of a stay violation was not a final order in the absence of a decision fixing damages.

Because there was no final order, Judge Faris said that Rule 9024 did not apply and that the “bankruptcy court was free to review and change its own interlocutory order whether or not Rule 9024 permitted it to do so.”

Judge Faris therefore reviewed the reconsideration order *de novo*.

*Fulton* Means No Stay Violation

Citing *City of Chicago v. Fulton*, 141 S. Ct. 585, 208 L. Ed. 2d 384 (Sup. Ct. Jan. 14, 2021), Judge Faris saw no error when the city “failed to move to quash the writ of garnishment or cause [the bank] to unfreeze the bank accounts.” To read ABI’s report on *Fulton*, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-holds-that-merely-holding-property-isn%E2%80%99t-a-stay-violation).

Before *Fulton*, Judge Faris cited the Ninth Circuit for having held that the knowing retention of estate property violates Section 362(a)(3). *Fulton*, he said, overruled those decisions.

Judge Faris quoted *Fulton* for saying that Section 362(a)(3) contains no affirmative turnover obligation and that mere retention of estate property does not violate the stay. He affirmed the bankruptcy court’s ruling on subsection (a)(3) by saying that the city “had no affirmative duty to ensure the return of estate property to [the debtor].”

Judge Faris cited *Margavitch v. Southlake Holdings LLC (In re Margavitch)*, 20-00014, 021 BL 383922, 2021 Bankr. Lexis 2784, 2021 WL 4597760 (Bankr. M.D. Pa. Oct. 6, 2021), as being directly on point. In *Margavitch*, he described Bankruptcy Judge Mark J. Conway of Wilkes-Barre, Pa., as finding “no affirmative obligation to release the funds and [said that the creditor] need only maintain the *status quo*.” To read ABI’s report on *Margavitch*, [click here](https://www.abi.org/newsroom/daily-wire/refusing-to-release-an-attachment-after-filing-is-no-stay-violation-following).

Having found no violation of Section 362(a)(3), Judge Faris saw no violation of any other subsection in Section 362(a).

By promptly taking steps to stay the litigation in state court, Judge Faris said there was no violation of subsection (a)(1), which bars the continuation of a suit against a debtor. Because the city had done nothing to enforce the judgment or the writ, he saw no violation of subsection (a)(2).

Likewise, there was no act to recover a claim against the debtor and no violation of subsection (a)(6), because the city only maintained the *status quo*.

A Possible Qualification

Judge Faris concluded his opinion by saying there was no stay violation because the city “did nothing to change the *status quo*” and “immediately asked the state court to stay the case.”

Is there significance in Judge Faris’s use of the word “immediately”?

Assume that the motion was *sub judice* in state court to convey estate property to a creditor. Would the creditor violate the automatic stay if the creditor does not ask the state court to withhold a decision conveying property to the creditor?

[The opinion is](https://abi-opinions.s3.amazonaws.com/Stuart.pdf) *Stuart v. City of Scottsdale (In re Stuart)*, 21-1063 (B.A.P. 9th Cir. Nov. 10, 2021).

### Compensation

#### Absent an ‘actual conflict,’ disqualification is not automatic, the Third Circuit says.

# Judge Ambro Explains the Primacy of Section 327(a) over State Ethics Rules

The disqualification of a lawyer for a conflict in a bankruptcy case is governed by Section 327(a), the Third Circuit recently said. Absent an “actual conflict,” disqualification is discretionary and is not required under Section 327(a), even if there is a potential conflict.

The courts have discretion to apply the state’s rules of professional conduct when they are relevant and compatible with federal law and policy, Circuit Judge Thomas L. Ambro said for the Philadelphia-based appeals court in his opinion on May 24. Otherwise, the inquiry does not go beyond Section 327(a).

Boy Scouts’ Counsel

The Boy Scouts purchased primary insurance from an insurer that bought reinsurance from other insurers. The law firm at issue in the Third Circuit opinion was the primary insurer’s counsel in disputes with the Boy Scouts’ reinsurers. At about the same time the primary insurer retained the law firm, the Boy Scouts retained the same law firm to explore restructuring options in response to sexual abuse lawsuits.

In agreeing to represent the Boy Scouts, the firm told the organization that it would not give counsel on insurance coverage. The Boy Scouts retained another firm for insurance matters.

The primary insurer first learned that the firm was representing the Boy Scouts on reading an article in *The Wall Street Journal* about three months after hiring the firm for reinsurance disputes. The insurer did not object at the time.

As counsel for the Boy Scouts, lawyers from the firm attended some meetings with the primary insurer where the Boy Scouts was chiefly represented by the other firm. The insurer did not object at the time.

About 10 months after reading that the firm was also representing the Boy Scouts, the primary insurer told the firm that the dual representation was a conflict. The insurer also objected when the firm participated in mediation on the side of the Boy Scouts. The firm then responded by setting up a formal ethical screen between the firm’s bankruptcy and insurance lawyers.

The insurer refused to give the firm a waiver of the alleged conflict or to consent to the firm’s withdrawal. So, the firm withdrew unilaterally.

The firm filed the Boy Scouts’ chapter 11 petition in February 2020. The debtor filed an application to retain the firm as its bankruptcy counsel, but the primary insurer objected.

In an opinion that Judge Ambro called “well reasoned,” Bankruptcy Judge Laurie Selber Silverstein overruled the objection and authorized the firm’s retention. She saw no actual conflict and found that the firm’s two teams of lawyers had not shared the insurer’s confidential information. The district court affirmed, but the insurer appealed to the circuit.

In the meantime, the firm’s bankruptcy lawyers moved to a new firm, taking the Boy Scouts’ case with them. Consequently, the firm is no longer representing either the Boy Scouts or the insurer.

Jurisdiction and Standing

Arguably, the retention order was not a final order subject to appeal as of right. Much like the Second Circuit’s recent opinion in *Alix v. McKinsey & Co. Inc.*, 20-2548 (2d Cir. Jan. 19, 2022), Judge Ambro said that retention of counsel implicates the integrity of the bankruptcy system and is extremely important to resolve. For ABI’s report on *Alix*, [click here](https://www.abi.org/newsroom/daily-wire/second-circuit-expands-standing-to-ensure-integrity-of-the-bankruptcy-court).

Although the firm no longer represents the Boy Scouts, Judge Ambro found constitutional and prudential standing because the possibility of disgorgement of fees gave the appeal “continuing implications” for the debtor and its creditors.

Section 327 Disqualification

Judge Ambro’s opinion is a *tour de force* on disqualification under Section 327 and the relationship between Section 327 and states’ ethics rules. He began analyzing the merits by laying out the fundamentals of Section 327(a).

To be eligible for employment, the professional may not “represent an adverse interest” and must be “disinterested.” Although the two prongs are “distinct,” Judge Ambro said, “they effectively collapse into a single test” in the case on appeal.

Conflicts under Section 327 are divisible into three categories, Judge Ambro said: (1) actual conflicts; (2) potential conflicts; and (3) appearances of conflict. If there is an actual conflict, counsel face *per se* disqualification, the judge said.

On the other hand, disqualification is discretionary if the conflict is potential, and an attorney is not disqualified on the appearance of a conflict alone, Judge Ambro said.

“Pragmatically,” Judge Ambro said, “a conflict is actual when the specific facts before the bankruptcy court suggest that ‘it is likely that a professional will be placed in a position permitting it to favor one interest over an impermissibly conflicting interest.’” *In re Marvel Ent. Grp., Inc.*, 140 F.3d 463, 476 (3d Cir. 1998).

The bankruptcy court had found no actual conflict under Section 327. On appeal, the insurer “has not meaningfully challenged the Bankruptcy Court’s factual finding that [the firm] did not have an interest adverse to the estate,” Judge Ambro said. Therefore, the firm was not saddled with an actual conflict, for the purposes of the appeal.

The insurer argued that the bankruptcy court committed error by not also evaluating the dual representation under Rules 1.7 and 1.9 of the ABA’s Model Rules of Professional Conduct.

“We decline to do so,” Judge Ambro said, holding that “Section 327 and the Rules of Professional Conduct impose independent obligations.” He went on to say that “[p]rofessional conduct rules may be relevant and ‘consulted when they are compatible with federal law and policy . . . . *In re Congoleum Corp.*, 426 F.3d 675, 687 (3d Cir. 2005).’”

Thus, the appeal at best presented a potential conflict, requiring the court to determine whether the potential conflict implicated the economic interests of the estate. In that regard, the Boy Scouts had other insurance counsel, and the Boy Scouts were not a party to the reinsurance agreement where the firm was counsel for the principal reinsurer. Given the facts, “the conflict alleged by [the insurer] was outside the scope of § 327(a),” Judge Ambro held.

Although ethics rules “may be informative in some cases,” Judge Ambro said, “We never stated that violations of the Rules of Professional Conduct are themselves sufficient to create a § 327 conflict.” Therefore, Judge Ambro concluded that the bankruptcy court “reasonably ruled” that the dual representation did not require disqualification under Section 327.

Judge Ambro went on to explain that disqualification is never automatic. “Even when an ethical conflict exists (or is assumed to exist) [under state ethics rules], a court may conclude based on the facts before it that disqualification is not an appropriate remedy.”

In the case on appeal, the bankruptcy court did not decide whether the firm had violated any state ethics rules but decided that disqualification was inappropriate. He found that the insurer could not have been adversely affected because the firm’s bankruptcy team had not received any confidential information.

To the contrary, the Boy Scouts would have been adversely affected had the firm been disqualified. Judge Ambro therefore ruled that the bankruptcy court’s decision was “nowhere close to an abuse of discretion.” He affirmed.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Boy+Scouts+retention.pdf) *In re Boy Scouts of America*, 21-2035 (3d Cir. May 24, 2022).

#### Being seen at bar events in the company of those who appear in court doesn’t show judicial bias.

# Bankruptcy Courts Have ‘Core’ Power to Order Fee Disgorgement, Third Circuit Says

Sometimes, nonprecedential opinions have something important to say. And sometimes, opinions are fun to read.

As so it was with an April 19 opinion for the Third Circuit by Circuit Judge Kent A. Jordan. He began by alluding to “the famous first law of holes: when you’re in one, stop digging.”

Judge Jordan devoted the first eight pages of his April 19 opinion to laying out the dimensions of the hole that the chapter 11 debtor’s lawyer had dug for himself. Basically, the lawyer failed to disclose a $19,000 payment he had received from the debtor’s owner. The payment only came out when the lawyer filed an application for compensation after conversion to chapter 7.

Although the lawyer’s story changed from time to time, he claimed that the payment was a loan from the owner to be repaid after a final allowance. Whatever the circumstances, the payment should have been disclosed early and often.

Judge Jordan said that the lawyer “evaded” and made “contradictory responses” to questions by the bankruptcy judge about the undisclosed payment.

Bankruptcy Judge Stacey L. Meisel of Newark, N.J., denied the fee application with prejudice and ordered the lawyer to disgorge the payment. Given the lawyer’s “egregious” conduct, she also referred the matter to the chief district judge for an ethics investigation.

The district court affirmed. The lawyer fared no better in the circuit.

The lawyer led off by arguing that the bankruptcy court had no constitutional power to order disgorgement under *Stern v. Marshall*, 564 U.S. 462 (2011). He theorized that the dispute was not core because the payment came from a third party and not from the estate.

Judge Jordan dispensed with the contention by citing Third Circuit precedent, *In re Lazy Days’ RV Ctr. Inc.*, 724 F.3d 418 (3d Cir. 2013). There, the Third Circuit said that the payment of legal fees is “based on a federal bankruptcy law provision [not a state tort claim] with no common law analogue, so the *Stern* line of cases is plainly inapposite.” *Id*. at 423.

Violation of disclosure requirements “are thus appropriately policed through equitable remedies fashioned by the Bankruptcy Court,” Judge Jordan said. He held that the “fees paid by [the owner] were to the benefit of the estate and thus were core matters within the Bankruptcy Court’s purview.”

Failing on constitutional grounds, the lawyer argued that the bankruptcy judge abused her discretion in ordering disgorgement. Responding to the argument, Judge Jordan said, “The word ‘chutzpah’ comes to mind.”

The “repeated violations” of the Code and Rules and the “lack of candor,” Judge Jordan said, “more than justified entry of the Fee [disgorgement] Order.”

Judge Jordan ended his opinion by telling bankruptcy judges that they need not fear being seen in the company of those who appear in their courts.

Claiming judicial bias, the lawyer cited a photograph of the bankruptcy judge standing with the chapter 7 trustee at a bar event. Judge Jordan said that “[i]t does not” evidence bias.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Greenville+Ave.pdf) *In re Greenville Ave. LLC*, 21-2164 (3d Cir. April 19, 2022).

#### Officers are presumptively disqualified from KERPs, “absent a strong showing that they do not perform any significant role in management,” a district judge in New York says.

# Being an ‘Officer’ Disqualifies Someone from a KERP, New York District Judge Says

Reversing a bankruptcy court in New York, District Judge J. Paul Oetken held that someone with the title of a corporate officer is not entitled to participate in a key employee retention program, or KERP, “absent a particularly strong showing that they do not perform a significant role in management.”

In his July 9 opinion, Judge Oetken also held that the appeal was not equitably moot, even though the KERP payments had been made to six officers and the U.S. Trustee had not sought a stay pending appeal.

On the subject of who is or is not an “officer” for the purpose of Section 503(c), Judge Oetken referred to the “messy state of the law on this topic.” The section prohibits retention payments to an “insider” absent evidence that the payment is “essential” to retain someone who has a *bona fide* offer from another business. In turn, an “insider” is defined in Section 101(31)(B)(ii) to include an “officer.”

The Six Corporate Officers and the KERP

The chapter 11 debtor established an $8 million KERP for 190 employees. The group included six officers slated for retention bonuses aggregating $1.8 million.

Among the six, one was the deputy general counsel, three were senior vice presidents, and two were vice presidents. The debtor conceded that all six were deemed to be officers under Delaware law.

The U.S. Trustee objected to approval of the KERP as to the six officers. The bankruptcy judge overruled the objection and approved the KERP across the board, adopting the debtor’s argument that the six were officers in name only and had no broad decision-making authority.

The U.S. Trustee appealed but did not seek a stay pending appeal. The KERP payments were made to everyone. The chapter 11 plan was confirmed and consummated.

Equitable Mootness

The debtor contended that the appeal was equitably moot because the U.S. Trustee had not sought a stay pending appeal and requiring repayment would be inequitable.

To determine whether the appeal was moot, Judge Oetken applied the five-part *Chateaugay* test. *See In re Chateaugay Corp.*, 10 F.3d 944, 952 (2d Cir. 1993).

Among the tests relevant to the case on appeal, Judge Oetken saw no reason he could not provide relief by compelling disgorgement. Further, the six officers knew about the appeal and had been represented by the debtor, effectively speaking.

It was “regrettable,” Judge Oetken said, that the U.S. Trustee had not sought a stay, but clawing back the payments would not be “inequitable” if the payments were illegal in the first place.

Judge Oetken decided that the appeal was not equitably moot, noting that the lack of a stay “is much more dire” on appeal from a confirmation order.

The Significance of Being an ‘Officer’

In approving the KERP, the bankruptcy court applied a functional test to determine whether the six officers had “sufficient authority” to be seen as officers under Section 503(c). The debtor argued that being an officer under Delaware law was neither controlling nor dispositive.

“From a policy standpoint,” Judge Oetken said, “giving more weight to an objective criterion — whether an employee was appointed by the board — provides better guidance to parties than a functional, non-exhaustive test.”

Although a “functional approach” may be appropriate “in many cases,” Judge Oetken agreed “with the [U.S.] Trustee that with respect to officers *appointed or elected by the Board*, such individuals are ‘officers’ under the Bankruptcy Code, at least absent a particularly strong showing that they do not perform a significant role in management.” [Emphasis in original.]

Judge Oetken concluded that the bankruptcy court “erred by inquiring beyond the fact that the six employees were appointed by [the] board.” Even had he made a “more expansive analysis” beyond the fact that the six were appointed by the board and were officers under Delaware law, Judge Oetken said their designation as officers would be “dispositive, at least absent a strong showing that they do not perform any significant role in management.”

In the case at hand, Judge Oetken said that the debtor “failed to overcome the strong presumption that, as board-appointed employees, the six employees are officers.” He therefore reversed the order approving the KERP as to the six officers.

The Standards on Appeal

In a footnote at the conclusion of his decision, Judge Oetken said that the case presented mixed questions of law and fact, where the issues were “primarily legal.” On that basis, he reversed on *de novo* review.

If the questions were “primarily factual,” Judge Oetken said, then the bankruptcy court’s conclusion that the six were not officers was “clearly erroneous.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/LSC+Comm.pdf) *Harrington v. LSC Communications Inc. (In re LSC Communications Inc.)*, 20-5006 (S.D.N.Y. July 9, 2021).

#### Closing a chapter 11 case after confirmation to avoid U.S. Trustee fees won’t be necessary if the ruling by Judge Sontchi holds up.

# Judge Sontchi Cuts Off U.S. Trustee Fees on Confirmation of a Chapter 11 Plan

When a trust created under a chapter 11 plan makes distributions to creditors, the distributions are not subject to fees for the U.S. Trustee system because transfers by a trust are not disbursements by the debtor, according to Delaware Chief Bankruptcy Judge Christopher S. Sontchi.

In his June 28 ruling, Judge Sontchi referred to the “absurdity” of the U.S. Trustee’s position. He added, “I cannot stress enough how offensive I find the [U.S. Trustee’s] attempt to double, or triple collect its ‘tax.’” On the other hand, he said that the U.S. Trustee has “admirably” fulfilled its role “as the watchdog over the integrity of the administration of the U.S. bankruptcy system.”

If Judge Sontchi’s theory prevails, U.S. Trustees won’t be collecting fees after confirmation of chapter 11 plans where distributions are made by trusts and not by the debtors. It will no longer be necessary to close chapter 11 cases to cut off taxes paid to the U.S. Trustee system.

The Litigation Trust

The facts were typical of significant chapter 11 cases. The debtors confirmed a plan in mid-2017 that created a litigation trust to which the debtors transferred their claims against third parties. For the quarter in which the assets were transferred to the trust, the debtors paid the maximum fee owing to the U.S. Trustee under 28 U.S.C. § 1930(a)(6).

After the transfers to the trust, the chapter 11 plan provided that the debtors would have no further interest in the assets transferred to the trust. The plan also provided that quarterly fees would be paid to the U.S. Trustee “when due in accordance with applicable law.” In addition, the plan said that the debtors would remain obligated to pay the quarterly U.S. Trustee fees until the cases were closed.

The trust brought suit in late 2017 asserting claims transferred from the debtors. The trust negotiated a $90 million settlement this year. Judge Sontchi approved the settlement, and the trust received the settlement proceeds. The U.S. Trustee filed a motion asking Judge Sontchi to compel the trust to pay fees when the settlement proceeds are distributed to creditors.

Judge Sontchi denied the motion.

The Debtors Didn’t Make Disbursements

The U.S. Trustee based the motion on 28 U.S.C. § 1930(a)(6), which calculates the fee based on “disbursements.” The maximum quarterly fee is now $250,000, following the increase effective in the first quarter of 2018.

Judge Sontchi cited the Fifth Circuit for saying that several circuits define “disbursements” to mean payments made by or on behalf of the debtor. He went on to quote the Sixth Circuit for saying that “disbursements” is “commonly understood in this context to apply to payments made with the funds generated from the liquidation of the debtor’s assets.” *Robiner v. Danny’s Mkts., Inc. (In re Danny’s Mkts., Inc.)*, 266 F.3d 523, 525 (6th Cir. 2001).

For Judge Sontchi, the “common thread” in the opinions “‘is the fact that the debtor had some interest in, or control over, the money disbursed,’” quoting *In re Hale*, 436 B.R. 125, 130 (Bankr. E.D. Cal. 2010). Quoting a district judge in Delaware, he said “‘it is the ultimate payment of the expense by any entity on behalf of a debtor that is the subject of quarterly fees.’” *Walton v. Post-Confirmation Comm. of Unsecured Creditors of GC Companies, Inc. (In re GC Companies, Inc.)*, 298 B.R. 226, 230 (D. Del. 2003).

The trigger for payments of U.S. Trustee fees is commonly understood to be payments by or on behalf of the debtor, Judge Sontchi said. In the case at bar, the U.S. Trustee’s motion failed because “the Trust is not paying expenses on behalf of any Debtors.”

Rather, the disbursements triggering fees for the U.S. Trustee were made at confirmation when the debtors funded the trust. At the time, the debtors paid the maximum fees to the U.S. Trustee.

Judge Sontchi dug deeper into the plan to find further support for his conclusion. He cited the plan for providing that transfers to the trust were to be treated as transfers directly to trust beneficiaries — that is to say, to creditors.

Furthermore, the settlement proceeds were trust assets as to which the debtors had disavowed any further interest. Consistent with Section 1930, he said that the U.S. Trustee had already received its quarterly fee at confirmation based on transfers of claims made then by the debtor.

Judge Sontchi denied the U.S. Trustee’s motion because transfers to creditors by the trust were not “disbursements” on behalf of the debtors.

Observations

Judge Sontchi’s opinion gives tips on how to draft plans and related documents to cut off U.S. Trustee fees at confirmation.

In addition, the confirmation order could be written to provide that transfers by a trust will not be taxed by the U.S. Trustee. That way, the U.S. Trustee would be tasked with appealing the confirmation order and could not wait to claim fees after the trust makes disbursements.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Paragon+Offshore+UST+Fees.pdf) *In re Paragon Offshore PLC*, 629 B.R. 227 (Bankr. D. Del. June 28, 2021).

### Preferences, Fraudulent Transfers & Claims

#### Circuit courts differ on their understanding of Supreme Court precedent and are now split 3/3 on whether a real estate tax foreclosure can be set aside as a constructive fraudulent transfer.

# Split Grows on Barring Fraudulent Transfer Attacks on Real Estate Tax Foreclosures

Add the Sixth Circuit to the courts holding that real estate tax foreclosures can be attacked as fraudulent transfers despite *BFP v. Resolution Trust*, 511 U.S. 531 (1994), where the Supreme Court ruled that mortgage foreclosures are immune from fraudulent transfer attack.

Although the appeals court’s decision was non-precedential, the opinion has equally important language about limitations on the *Rooker-Feldman* doctrine.

The Circuit Split

Regarding tax foreclosure, the Third, Sixth and Seventh Circuits now hold that they can be attacked as fraudulent transfers. Regarding the Third Circuit, *see* *Hackler v. Arianna Holdings Co., LLC*, 938 F.3d 473 (3d Cir. 2019). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/new-jersey-tax-foreclosures-can-be-preferences-third-circuit-rules). Regarding the Seventh Circuit, *see* *Smith*, *infra*.

The Fifth, Ninth and Tenth Circuits hold to the contrary, having extended *BFP* from immunizing mortgage foreclosures to protecting tax foreclosures. The most recent of those decisions came from the Ninth Circuit. *See* *Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI’s report on *Tracht Gut*, [click here](https://www.abi.org/newsroom/daily-wire/regularly-conducted-tax-sales-cannot-be-fraudulent-transfer-ninth-circuit-holds).

Delinquent Taxes

In the Sixth Circuit appeal, the debtor had been several years behind in paying real estate taxes on his home. The county obtained a final judgment of foreclosure. Because the debtor did not redeem the property by paying the taxes on time, the city exercised its statutory right to purchase the property for the amount of the unpaid taxes, about $14,500.

At the time, the property was assessed for $104,000. The debtor alleged that the fair market value was $152,000.

The debtor filed a chapter 13 petition and a complaint alleging that the tax sale could be avoided as a constructively fraudulent transfer under Section 548(a)(1)(B). The city filed a motion for summary judgment and won.

The bankruptcy court reasoned that the *Rooker-Feldman* doctrine barred relitigating the state court foreclosure. The bankruptcy court also said that the fraudulent transfer attack was precluded by *BFP*.

The debtor appealed. The district court affirmed, but based only on *BFP*. The debtor appealed again and won a remand.

By the way, the debtor remains in chapter 13, having confirmed a plan.

*Rooker-Feldman*

In his December 27 opinion, Circuit Judge John M. Rogers first dealt with *Rooker-Feldman*. Named for two Supreme Court decisions, the doctrine bars lower federal courts from engaging in appellate review of state court judgments.

Judge Rogers quoted the Supreme Court for saying that *Rooker-Feldman* is a narrow doctrine that should not be applied broadly. He cited the Third Circuit for holding that the court may decide whether foreclosure amounted to a fraudulent transfer under Section 548 while still assuming that the state court foreclosure was proper. *See In re Philadelphia Ent. & Dev. Partners*, 879 F.3d 492, 500-01 (3d Cir. 2018). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/third-circuit-pushes-back-on-widespread-invocation-of-rooker-feldman).

In the case on appeal, Judge Rogers ruled that *Rooker-Feldman* “does not apply here because this appeal does not involve a review of the merits of a state court judgment.” He said that the debtor’s “alleged injury in this case is not the state court foreclosure judgment, but instead is the fact that he could not use § 548 to avoid the foreclosure as a fraudulent transfer.”

The bankruptcy court therefore erred in barring the fraudulent transfer claim under *Rooker-Feldman*.

*BFP*

Next, Judge Rogers tackled the bankruptcy court’s second ground for dismissal, the expansion of *BFP* to cover real estate tax foreclosures.

Tersely, Judge Rogers said that the “Supreme Court’s rule in *BFP* does not apply to the facts of this case,” because the Supreme Court was ruling on mortgage foreclosure, not tax foreclosure.

Judge Rogers noted the differences between the two types of foreclosure. In tax foreclosure in Michigan, there is no public auction and no minimum bid. In the case on appeal, the sale price of $14,500 “had no apparent relation to the value of the property and was only about ten percent of the alleged fair-market value.”

Based on the same factual distinctions, Judge Rogers cited the Seventh Circuit for “persuasively” holding “that *BFP* did not extend to the state court tax foreclosure at issue.” *See In re Smith*, 811 F.3d 228, 234 (7th Cir. 2016). For ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/sale-of-delinquent-tax-certificates-leads-to-fraudulent-transfer-seventh-circuit).

Judge Rogers held that the two grounds for upholding dismissal of the suit are “insufficient at this juncture.” However, he was unable to award judgment altogether to the debtor.

Remand

There were two undecided issues that precluded the Sixth Circuit from granting judgment in favor of the debtor. First, the lower courts had not decided whether the debtor was insolvent on filing and thus eligible to raise a claim for a constructively fraudulent transfer. Second, there was an unresolved question about the debtor’s ability to attack the sale once the redemption period had elapsed.

So, Judge Rogers reversed and remanded, saying that the “district court may in its discretion further remand the case to the bankruptcy court.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Lowry.pdf) *Lowry v. Southfield Neighborhood Revitalization Initiative (In re Lowry)*, 20-1712 (6th Cir. Dec. 27, 2021).

#### Judges again refuse to make an exception for trustees regarding the judge-made doctrine of in pari delicto.

# Fourth Circuit Rejects Frontal Assault on *In Pari Delicto* as a Bar to Suits by a Trustee

*In pari delicto* is the bane of bankruptcy trustees. Invocation of the judge-made rule of equity can preclude a trustee from suing non-debtor third parties who assisted the debtor’s wrongdoing.

To no avail, a bankruptcy trustee in South Carolina mounted a frontal assault in the Fourth Circuit on *in pari delicto*, which means “in equal fault.”

The doctrine was originally invented by English courts to bar one thief from suing a cohort for part of the stolen goods. Today, *in pari delicto* bars a plaintiff from suing a defendant when the plaintiff was in equal or greater fault.

Some states have adopted exceptions, such as the “adverse interest exception,” which bars the defense when an agent was acting for the agent’s own benefit and abandoned the interests of the corporation.

In the South Carolina chapter 7 case, officers of the corporate debtor had cooked the books with assistance from an outside accounting firm. The trustee sued the corporate officers, the accountants and the debtor’s financial advisors. Everyone defaulted or settled, except the financial advisors. Some of the defendants went to jail.

The suit against the financial advisors asserted claims including common law fraud, breach of fiduciary duty and aiding and abetting breach of fiduciary duty.

After an 18-day bench trial, the bankruptcy judge gave judgment in favor of the financial advisors. The court decided that the trustee had failed to establish the elements of any of the claims. In addition, the bankruptcy court ruled that the defense of *in pari delicto* barred the suit.

The district court affirmed on the same grounds, prompting another appeal where Circuit Judge Toby J. Heytens affirmed in an opinion on April 19.

The trustee advanced five theories designed to forestall invocation of *in pari delicto*. Judge Heytens knocked them down one by one.

First, the trustee argued that *in pari delicto* should not apply because he represented both the debtor and blameless creditors. The argument got nowhere.

Judge Heytens cited the Fourth Circuit for holding in 2013 that “a trustee proceeding under 11 U.S.C. § 541 is subject to the same defenses as the debtor *because* the trustee stands in the debtor’s shoes in such an action.” *Grayson Consulting, Inc. v. Wachovia Secs., LLC*, 716 F.3d 355, 367 (4th Cir. 2013). [Emphasis in original.]

In *Grayson*, Judge Heytens said, the Fourth Circuit “specifically held that this includes *in pari delicto*.”

Judge Heytens therefore held that “the trustee is plainly subject to *in pari delicto* to the extent he brings this action under Section 541.” That section creates an estate with all of the debtor’s legal and equitable interests.

Next, the trustee contended that *in pari delicto* should not apply because he was exercising the powers of a hypothetical judicial lien creditor under Section 544(a)(1).

Under applicable Nevada law, Judge Heytens said that a judgment creditor has no greater rights than the debtor. He therefore held, “[W]hen a bankruptcy trustee steps into the shoes of a hypothetical creditor who would herself stand in the shoes of the debtor in bringing a given action, the trustee is still subject to the same defenses as the debtor, including *in pari delicto.*”

Third, the trustee argued that someone who colluded with the debtor cannot invoke the doctrine under principles of agency.

On the facts, Judge Heytens alluded to the bankrupty court’s finding that there was no collusion and therefore no basis for invoking the exception to *in pari delicto*.

Fourth, the trustee contended that the doctrine did not apply because the corporate officers were acting adversely to the debtor’s corporate interests.

In Nevada, like “most jurisdiction,” Judge Heytens said, the exception only applies when the agent’s actions have been “completely and totally adverse” to the corporation. In response, the trustees argued that South Carolina law only requires that the interests be “clearly adverse.”

Judge Heytens did not “see much daylight” between the two standards. It “simply is not a close case,” he said, because the corporation derived benefits from the misconduct, such as raising capital and extending the life of the business.

Finally, the trustee argued that Nevada and South Carolina would follow Delaware by holding that *in pari delicto* is inapplicable to violations of fiduciary duties or aiding and abetting.

To the contrary, Judge Heytens said that Nevada “squarely held” to the contrary. In a factually similar South Carolina appellate decision, he said that *in pari delicto* “barred a breach of fiduciary duty claim.”

Upholding the lower courts, Judge Heytens ended his opinion by saying that the debtor’s “officers and auditors were the authors of the company’s demise — not [the financial advisors]. At worst, the [advisors] simply failed to stop a ship that was already sinking, and the law does not hold them responsible for that failure.”

[The opinion is](https://abiworld.box.com/s/oq02dlejzvu7dxjbmtn8354yrx72v0y7) *Anderson v. Morgan Keegan & Co. (In re Infinity Business Group Inc.)*, 21-1536 (4th Cir. April 19, 2022).

#### There can be no question about whether the beneficiary of a surety bond has been ‘paid in full’ before the surety has subrogation rights.

# Third Circuit Makes Strict Rules Before Subrogation Rights Kick In

Affirming Bankruptcy Judge Christopher S. Sontchi of Delaware, the Third Circuit explained the meaning of Section 509(c), the most incomprehensible provision in the Bankruptcy Code.

In essence, the Third Circuit rigorously interpreted “paid in full” in Section 509(c) to benefit the beneficiary of a payment and performance bond. There can be no question about whether the beneficiary of the bond has been paid in full before the bonding company is subrogated to the claim and rights of the beneficiary.

The Contracts and the Bond

A contractor had multiple contracts with the U.S. government. The contractor was required to post a payment and performance bond.

The contractor defaulted on one of the construction contracts. The government tapped on the shoulder of the bonding company, which hired another contractor to complete the job.

According to the August 18 opinion by Chief Circuit Judge D. Brooks Smith, the bonding company was out of pocket by some $12 million more than the government paid to complete the project.

The defaulting contractor ended up in chapter 7. Just before bankruptcy, the contractor filed an income tax return and claimed a $5.5 million carryback refund from the IRS.

The bonding company was still paying to complete the project while the bankruptcy was in progress. The government notified the bonding company in February 2016 that the project was “sufficiently complete” to allow occupancy. However, the bonding company did not make the final payment to the replacement contractor until September 2016.

The government filed a claim against the contractor for some $170 million, including more than $80 million on the bonded project.

On the other side of the fence, the trustee was contending that the government owed more than $50 million on other projects.

The disputes led to a compromise with the bankruptcy trustee where the government agreed to release the $5.5 million refund to the trustee and waive its setoff rights. In return, the government was given an allowed unsecured, nonpriority claim for $170 million.

The bonding company objected to the settlement, claiming it was subrogated to the government’s rights to the $5.5 million tax refund. The objection resulted in a companion settlement where the $5.5 million was held in escrow, and the bonding company was assured that the primary settlement would not waive the bonding company’s claims, “if any,” to the tax refund.

The bankruptcy court approved the primary settlement in June 2016, waiving the government’s setoff rights. Note that the bonding company would not make the final payment to the replacement contractor until September 2016.

In approving the settlement and overruling the bonding company’s objections, Bankruptcy Judge Sontchi granted summary judgment in favor of the secured lender that had a lien on the contractor’s assets, including the tax refund. Judge Sontchi concluded that the government had not been “paid in full” when the waiver became effective. He therefore ruled that the government was entitled to waive its right of setoff and thus defeat the bonding company’s subrogation rights.

The district court affirmed, and so did Judge Smith.

‘Paid in Full’ in Section 509(c)

Judge Smith began by laying out the common law elements of subrogation and explained how they were modified by Section 509.

Departing from common law, Judge Smith said that “Section 509(a) provides that a surety is partially subrogated to the rights of a creditor to the extent that the surety has made *any* payments (*i.e.*, short of payment in full).” [Emphasis in original.]

Fortunately for us, Judge Smith translated Section 509(c) into plain English. The subsection, he said, “provides that those subrogation rights are subordinated to the remainder of the creditor’s claim until the creditor has been paid in full.” He cited legislative history as reflecting the concern of Congress that the statute should not permit a bonding company to compete with the insured until the insured’s claim has been paid in full.

Judge Smith said that the statute does not define “paid in full.” There are broad and narrow interpretations of the words. Under either, the bonding company loses, he said.

The broad interpretation requires full payment of all claims that the beneficiary of the bond has against the contractor, not just the contract to which the bond applied. Under that definition, the bonding company would lose because the government had many other unpaid claims against the bankrupt contractor.

The narrow construction requires full payment of the claims covered just by the bond. Thus, Judge Smith launched into an analysis of whether the government had been paid in full by June 2016, when the government waived its right to set off the tax refund.

Judge Smith said there was “no evidence in the record” to show that the government had been paid in full when the waiver was made. To the contrary, he said, the government was not paid in full until the bonding company made the last payment to the replacement contractor months after the waiver.

Judge Smith also said that the bonding company’s agreement years before to complete the project did not in itself “satisfy” the bonding company’s suretyship obligations.

Affirming Judge Sontchi, Judge Smith held that the government had not been “paid in full” under Section 509(c) before the bankruptcy court approved the settlement waiving the government’s right of setoff. The bonding company was not yet subrogated and had no right to object to the government’s waiver of setoff rights.

[The opinion is](about:blank) *Giuliano v. Insurance Co. of Pennsylvania (In re LTC Holdings Inc.)*, 20-3057 (3d Cir. Aug. 18, 2021).

#### Circuit Judge Ambro generously interprets Katz to mean that ratification of the Constitution waived state sovereign immunity broadly for suits to augment a bankrupt estate.

# Third Circuit Finds Broad Waiver of Sovereign Immunity for Suits Augmenting the Estate

In *Katz*, the Supreme Court ruled that states waived sovereign immunity for some types of bankruptcy proceedings when the states ratified the Constitution with its Bankruptcy Clause.

Third Circuit Judge Thomas L. Ambro generously interpreted *Katz* to find a broad waiver of sovereign immunity when a debtor sues the state to augment the estate. More particularly, Judge Ambro ruled that sovereign immunity does not prevent a liquidating trustee from bringing an inverse condemnation suit against the state.

The Inverse Condemnation Suit

A company leased an offshore oil-production platform from the State of California and owned an onshore facility for processing and refining oil. A rupture in the pipeline forced the company into chapter 11, where it abandoned the lease for the platform. Walking away from the platform gave the state large claims for plugging and abandoning the wells.

Invoking police powers, the state took the position that it could take over the onshore facility without payment. After the company confirmed a liquidating chapter 11 plan, the liquidating trustee mounted an inverse condemnation suit against the state in bankruptcy court.

In his May 24 opinion, Judge Ambro explained that inverse condemnation occurs when an owner sues the government for the value of property that was taken. Direct condemnation is when the government initiates proceedings to acquire title under its eminent domain authority.

The state filed a motion to dismiss, claiming the suit was barred by sovereign immunity. The bankruptcy court denied the motion to dismiss, and the district court authorized a direct appeal, but only regarding sovereign immunity. The Third Circuit accepted the appeal and heard argument in late September 2020.

Constitutional Waiver via *Katz*

The opinion reads like a treatise laying out various circumstances when states have no sovereign immunity. Although not involved in the appeal, legislation can waive state sovereign immunity when “Congress unequivocally expresse[s] its intent to end immunity,” Judge Ambro said. *See*, *e.g.*, Section 106.

Then came *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), where the Supreme Court ruled there was no sovereign immunity barring a debtor from suing a state instrumentality to recover a preference.

Judge Ambro identified three principles arising from *Katz*. First, by ratifying the Constitution containing the Bankruptcy Clause, states waived sovereign immunity in certain bankruptcy proceedings designed to “effectuate the *in rem* jurisdiction of the bankruptcy courts.” *Id.* at 378.

Second, *Katz* did not say that foreign immunity is waived in all bankruptcy proceedings. *Id*.

Third, Judge Ambro said that *Katz* “does not require a proceeding to be technically *in rem*” if the action is ancillary to and in furtherance of *in rem* jurisdiction, even if the action involves *in personam* process. *Id*. at 370 and 372.

Judge Ambro summarized *Katz’s* holding as follows: “States cannot assert a defense of sovereign immunity in proceedings that further a bankruptcy court’s *in rem* jurisdiction no matter the technical classification of that proceeding.”

Applying *Katz* to Inverse Condemnation

Judge Ambro read *Katz* as identifying three functions where proceedings are in furtherance of *in rem* jurisdiction: (1) exercising jurisdiction over estate property; (2) equitably distributing estate property; and (3) effectuating the debtor’s discharge. The court, he said, “must focus on function, not form.”

The inverse condemnation suit, Judge Ambro said, “furthers the Bankruptcy Court’s exercise of jurisdiction over property of the Debtors and their estates, as it seeks a ruling on rights in the Onshore Facility.” Although the suit was not clearly *in rem*, he said that “its function is to decide rights in [the debtor’s] property” and whether the state can use the debtor’s property “for free.”

Because the onshore facility was a “significant asset,” Judge Ambro said that the suit “also furthers the second critical function — facilitating equitable distribution of the estate’s assets.”

Confirming the plan did not reinstate the state’s immunity. Judge Ambro held that “critical *in rem* functions did not end when the Plan became effective, as the Trust exists primarily to facilitate the ‘equitable distribution of [the debtor’s property] among the debtor’s creditors,’” quoting *Katz* at 546. Moreover, he said that the estate’s *in rem* jurisdiction extended to estate property that was transferred to the liquidating trust.

Judge Ambro therefore held that the state’s “defense of Eleventh Amendment immunity fails.”

Finally, Judge Ambro rejected the idea that the state enjoyed sovereign immunity under California law. If that were true, he said that “state legislation [could] easily end-run the deemed waiver of state sovereign immunity effected by the Bankruptcy Clause and recognized in *Katz*.”

Having found a constitutional waiver of sovereign immunity, Judge Ambro did not reach the additional question of whether the state had waived immunity by filing a proof of claim.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Venoco+3d+Cir.pdf) *Davis v. California (In re Venoco LLC)*, 20-1061 (3d Cir. May 24, 2021).

#### Reducing a claim between the first and second bankruptcy didn’t prevent the Fifth Circuit from employing res judicata.

# *Res Judicata* Limits an Objection to a Claim Allowed in a Prior Bankruptcy

*Res judicata* limits the ability of a debtor in a second chapter 11 case to object to a claim allowed in a prior bankruptcy, the Fifth Circuit said.

A company and its individual owner were in parallel chapter 11 cases. The two debtors proposed and confirmed a joint plan.

The plan allowed the claim of a secured creditor for $1.8 million (rounded off). The plan called for the claim to accrue 5% interest and to be paid in 59 equal installments, with a so-called balloon payment in the 60th month.

After the 38th payment, the company filed in chapter 11 again and stopped making payments under the plan from the prior case. In the new case, the lender filed a proof of claim for $1.3 million (rounded off).

The corporate debtor objected to the $1.3 million claim, contending that most of the original $1.8 million claim was owing solely by the owner. Bankruptcy Judge Ronald B. King overruled the objection, holding that the objection was barred by *res judicata*, among other theories.

The district court affirmed, and so did Circuit Judge Edith Brown Clement in an opinion on November 15.

First, Judge Clement dealt with the bankruptcy court’s subject matter jurisdiction.

The corporate debtor argued that most of the debt was owed only by the individual, thus giving the bankruptcy court no subject matter jurisdiction to rule on the allowance of a debt owed by a non-debtor.

“[W]hether the bankruptcy court’s allowance of [the lender’s] claim was *proper* is an entirely different question from whether it had the *jurisdiction* to do so,” Judge Clement said. She held that the “*propriety* of the bankruptcy court’s determination to allow or disallow a claim against the debtor’s estate is simply not a jurisdictional inquiry.” [Emphasis in original.]

Next, Judge Clement analyzed whether the requisites of *res judicata* were satisfied.

There was no dispute about three elements: (1) The lender and the debtor were both parties in the first bankruptcy; (2) confirmation in the first bankruptcy was final; and (3) the bankruptcy court had jurisdiction in the first bankruptcy.

The debtor disputed the fourth element: whether the objection in the second bankruptcy arose out of the same transaction that underlay the prior bankruptcy.

The Fifth Circuit employs a “transactional test,” Judge Clement said. Citing *Nilsen v. City of Moss Point*, 701 F.2d 556, 560 (5th Cir. 1983) (*en banc*), she asked whether the two actions were based on the “same nucleus of operative facts.”

In the case on appeal, Judge Clement inquired as to “whether the transactions at the heart of [the debtor’s] claim objection in the second bankruptcy were the source of [the lender’s] claim in the first bankruptcy.” In other words, was the claim objection in the second bankruptcy “based on the same transaction or series of transactions that gave rise to the terms of the [chapter 11 plan in the first bankruptcy] as it relates to the amount of [the lender’s] claim”?

Judge Clement held “that it is,” because the objection in the second case “depends entirely on” the subject matter “that formed the basis” for the lender’s claim in the first bankruptcy.

Even if all four elements were present, Judge Clement said that *res judicata* would not apply unless the debtor “could have or should have” raised the claim in the first bankruptcy.

Since the claim objection in the second bankruptcy was “undeniably a question” about the propriety of the claim in the first bankruptcy, Judge Clement said the debtor could have raised the objection in the first bankruptcy. Consequently, she said, the debtor was precluded from contending that the claim had been allowed “for the wrong amount.”

Judge Clement raised a caveat. *Res judicata* did not prevent the debtor “from maintaining *any* claim objection in the second bankruptcy.” [Emphasis in original.] The doctrine only barred “a claim objection that is premised, in part or in whole, on the impropriety of [the lender’s] claim from the” plan in the first bankruptcy.

The claim had been reduced between the first and second bankruptcies, raising the question of whether the allowance of the claim in the second bankruptcy for $1.3 million was the correct amount. That issue, Judge Clement said, was “merely a factual determination reviewed for clear error.”

Examining the evidence and the bankruptcy judge’s findings in the second bankruptcy, Judge Clement found no clear error and affirmed.

[The opinion is](https://abi-opinions.s3.amazonaws.com/BVS+Construction.pdf) *BVS Construction Inc. v. Prosperity Bank (In re BSV Construction Inc.)*, 21-50274 (5th Cir. Nov. 15, 2021).

#### Over a vigorous dissent, the First Circuit Joins the Ninth Circuit by holding that Section 106(a) waives tribes’ sovereign immunity.

# Circuits More Deeply Split on Waiver of Sovereign Immunity for Native American Tribes

Deepening a split of circuits, the First Circuit held over a lengthy dissent that the Bankruptcy Code waived sovereign immunity as to tribes of Native Americans.

The majority’s May 6 opinion by Circuit Judge Sandra L. Lynch took sides with the Ninth Circuit, which had held in 2004 that Section 106(a) abrogated sovereign immunity for tribes. *Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055, 1061 (9th Cir. 2004).

Judge Lynch disagreed with the Sixth Circuit, which found no waiver in 2019. *In re Greektown Holdings, LLC*, 917 F.3d 451, 460- 61 (6th Cir. 2019), *cert. dismissed sub nom. Buchwald Cap. Advisors LLC v. Sault Ste. Marie Tribe*, 140 S. Ct. 2638 (2020). While the *certiorari* petition was pending in *Greektown*, the case settled, and the petition was dismissed. To read ABI’s report on *Greektown*, [click here](https://www.abi.org/newsroom/daily-wire/creating-a-split-sixth-circuit-holds-no-waiver-of-immunity-for-indian-tribes).

Chief Circuit Judge David J. Barron “respectfully” dissented. His 33-page dissent is half again as long as the majority’s.

The likelihood of a petition for *certiorari* is high. Assuming there is a petition, Prof. Jack F. Williams told ABI he “believe[s] that *certiorari* will be granted.” Prof. Williams is a professor at Georgia State University College of Law and the university’s Middle East Studies Center. He is a leading authority on both bankruptcy law and tribal law.

The Compelling Facts

Someone wanting a waiver of sovereign immunity could not have found more compelling facts.

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

Despite the automatic stay and despite being told about the bankruptcy, the tribal lender continually called the debtor demanding payment.

Two months after bankruptcy, the debtor attempted to commit suicide, blaming his action on the incessant calls.

In bankruptcy court, the debtor sought an injunction to halt collections attempts, along with damages and attorneys’ fees. The bankruptcy court granted the tribe’s motion to dismiss, based on sovereign immunity.

The First Circuit accepted a direct appeal.

The Majority Opinion

For the majority, Judge Lynch began by laying out the general principle that Congress must “unequivocally” express an intent to abrogate tribal sovereign immunity. Did Section 106(a) accomplish the task?

Section 106(a) says that “sovereign immunity is abrogated as to a governmental unit to the extent set forth in this section with respect to” dozens of provisions in the Bankruptcy Code, including Section 362. In turn, “governmental unit” is defined in Section 101(27) to mean:

United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States, (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or *domestic government*. [Emphasis added.]

Judge Lynch noted that Section 106 was amended in 1994 because the prior version had been held to be insufficiently clear to abrogate state and federal sovereign immunity.

For Judge Lynch, the question was whether “domestic government” includes tribes. She said there was “no real disagreement” that a tribe is a government.” It “is also clear,” she said, that a tribe is domestic.

Judge Lynch had “no doubt that Congress understood tribes to be domestic dependent nations . . . that are a form of domestic government.” “Thus,” she said, “a tribe is a domestic government and therefore a government unit.”

Having held that Congress “unmistakably abrogated the sovereign immunity of tribes,” Judge Lynch devoted the remainder of her opinion to countering arguments made by the tribe and the dissent. Noting that the Supreme Court does not require “magic words” to waive immunity, she first rejected the idea that the waiver could not apply to tribes without the use of the word “tribes” in the statute.

Next, Judge Lynch dismissed the argument that the legislative history led to ambiguity, because “legislative history cannot introduce ambiguity into an unambiguous statute.”

Judge Lynch did not agree with the idea that “domestic government” only refers to governments that arose under the Constitution. To the contrary, she said that “domestic refers to the territory in which the government exists.”

Finally, Judge Lynch said that an “interpretation of the phrase ‘domestic government’ that excludes Indian tribes with no textual basis for so doing is implausible.”

The Dissent

By failing to use the word “tribes” in the statute, Judge Barron said in dissent that Congress “did not use the surest means of clearly and unequivocally demonstrating that they are” governmental units.

Judge Barron asked:

Why, if Congress wanted to be crystal clear in abrogating tribal immunity through the Code, did it not use the clearest means of abrogating that immunity by including “Indian Tribe” — or its equivalent — in the list of expressly named governmental types that makes up the bulk of § 101(27)?

Judge Barron noted the peculiar absence of the word “tribes” in the Bankruptcy Code’s immunity waiver. He said that “Congress has expressly named them when abrogating their sovereign immunity in every other instance in which a federal court has found that immunity to have been abrogated.”

Judge Barron said he had “no choice but to conclude that § 101(27) does not clearly and unequivocally include Indian tribes, because, as I have explained, its text plausibly may be read not to cover them.”

Scholarly Commentary

“Aside from the split,” Prof. Williams told ABI that “this is an important issue striking at the meaning of sovereignty and self-determination of Indian tribes. This is especially the case in the commercial and economic landscape largely because it is through these vehicles a tribe can fund all the governmental activities that are necessary for tribal governance.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Coughlin.pdf) *Coughlin v. Lac du Flambeau Band of Lake Superior Chippewa Indians (In re Coughlin)*, 21-1153 (1st Cir. May 6, 2022).

#### The circuits are now split 2/1 on the waiver of sovereign immunity under Section 544(b) for lawsuits by a trustee based on claims that could have been made by an actual creditor.

# Circuit Split Widens Sovereign Immunity for Section 544(b) Claims

Taking sides on an issue that will likely reach the Supreme Court on a *certiorari* petition within the next year, the Fourth Circuit held that the Internal Revenue Service has no sovereign immunity protection to preclude an avoidance action under Section 544(b)(1).

Although it might seem obvious, Circuit Judge Marvin A. Quattlebaum, Jr. also held that tax penalties paid by a debtor are not avoidable as constructively fraudulent transfers.

The Sovereign Immunity Split

In 2017, the Ninth Circuit held in Zazzali v. U.S. (In re DBSI Inc.), 869 F.3d 1004 (9th Cir. Aug. 31, 2017), that the waiver of sovereign immunity under Section 106(a)(1) allows a trustee to file a derivative suit against the IRS for receipt of a state law fraudulent transfer under Section 544(b)(1). To read ABI’s report, [click here](about:blank).

The Ninth Circuit split with a Seventh Circuit opinion rendered three years earlier, In re Equipment Acquisition Resources Inc., 742 F.3d 743 (7th Cir. 2014). The Chicago-based appeals court reasoned that the waiver of immunity does not extend to Section 544(b)(1) suits because any actual creditor would have been barred from suing by the government’s sovereign immunity.

The Tenth Circuit is considering the issue now. In *U.S. v. Miller*, 20-00248, 2021 BL 340200 (D. Utah Sept. 8, 2021), the district court in Utah upheld Bankruptcy Judge R. Kimball Mosier by ruling that Section 106(a)(1) waives the federal government’s sovereign immunity with respect to underlying state law causes of action incorporated through Section 544(b). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/split-heading-to-the-tenth-circuit-on-sovereign-immunity-for-section-544b-claims).

The appellee’s brief in the Tenth Circuit is due this week. *See U.S. v. Miller*, 21-4135 (10th Cir.).

Tax Penalties Attacked

The corporate debtor had failed to pay state and local income taxes going back to 2003. The IRS assessed taxes, penalties and interest, some of which the debtor paid. The IRS also asserted liens.

In chapter 11, the IRS filed a claim for secured, unsecured priority and unsecured general claims.

After confirmation of a chapter 11 plan, the plan trustee sued the IRS under Section 544(b)(1) to avoid unpaid tax penalties, claiming that the payments were constructively fraudulent transfers under North Carolina’s version of the Uniform Voidable Transactions Act. Under the same theory, the plan trustee also sought to recover penalties that the debtor had paid.

The IRS raised sovereign immunity as a defense and also argued there was no fraudulent transfer on the merits.

The bankruptcy court found a waiver of sovereign immunity but dismissed the claims on the merits. The district court affirmed.

Sovereign Immunity Waived

On appeal to the circuit, the IRS contended there was sovereign immunity in bankruptcy court because sovereign immunity would have barred any actual creditor of the debtor from suing the IRS for a fraudulent transfer outside of bankruptcy court.

In his March 8 opinion, Judge Quattlebaum acknowledged the split but sided with the result reached in the Ninth Circuit. He said that the waiver of sovereign immunity in Section 106(a) “forecloses the government’s position that sovereign immunity bars any action by an unsecured creditor under” state law. Section 106(a)(1) includes Section 544 among the provisions in the Bankruptcy Code under which sovereign immunity “is abrogated as to a governmental unit.”

“In addition,” Judge Quattlebaum said, the filing of a claim by the IRS waived sovereign immunity under Section 106(b). That section says that a “governmental unit that has filed a proof of claim in the case is deemed to have waived sovereign immunity with respect to a claim against such governmental unit . . . .”

Because the IRS had filed a claim, Judge Quattlebaum said that “the government would have waived sovereign immunity if an unsecured creditor were to file a claim against it.”

No Claim on the Merits

The Fourth Circuit had not decided whether tax penalties could be fraudulent transfers, on the theory that the debtor received nothing in return. Judge Quattlebaum cited the Sixth Circuit for rejecting the same theory that the plan trustee had advanced. *See In re Southeast Waffles, LLC*, 702 F.3d 850 (6th Cir. 2012).

In *Southeast Waffles*, the Sixth Circuit said that Tennessee’s fraudulent transfer law required an “exchange,” but the IRS was an involuntary creditor. Tax penalties were imposed by operation of statute, with no value exchanged in the process.

Like Tennessee law, Judge Quattlebaum said that “North Carolina’s [Fraudulent Transactions] Act presumes a voluntary exchange between the debtor and the creditor” and “expressly” requires an “exchange.” The North Carolina fraudulent transfer law also requires “an oral or written agreement.”

“But none of that takes place with an IRS tax penalty obligation,” Judge Quattlebaum said. There was no written or oral agreement. “Since tax penalties are not obligations incurred as contemplated by the [state fraudulent transfer statute],” he said, the state law “cannot be the ‘applicable law’ required for [the plan trustee] to bring this action under 11 U.S.C. § 544(b)(1).”

There being no state law on which the plan trustee could base a Section 544(b)(1) claim, Judge Quattlebaum upheld dismissal of the claim to avoid unpaid tax penalty obligations.

Judge Quattlebaum also dismissed the claim to recover tax penalties that the debtor had paid, because there had been a dollar-for-dollar reduction in the debtor’s obligations.

Judge Quattlebaum added a proviso at the end of his opinion when he said that “our conclusion about the tax penalty payments turns on the legitimacy of the underlying tax penalty obligation.” In essence, he said that a payment might be recoverable if the underlying tax liability had been avoidable.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Yahweh.pdf) *Cook v. U.S. (In re Yahweh Center Inc.)*, 20-1685 (4th Cir. March 8, 2022).

#### The Tenth Circuit will likely take sides on a split between the Ninth and Seventh Circuits on Section 544(b) state-law claims brought by a trustee in the shoes of an actual creditor.

# Split Heading to the Tenth Circuit on Sovereign Immunity for Section 544(b) Claims

The Internal Revenue Service seems to be setting up the Tenth Circuit to take sides on the following circuit split:

Does the waiver of sovereign immunity under Section 106(a)(1) bar a trustee from suing the government under Section 544(b) for receipt of a fraudulent transfer based on *state* law?

In 2017, the Ninth Circuit held in Zazzali v. U.S. (In re DBSI Inc.), 869 F.3d 1004 (9th Cir. Aug. 31, 2017), that the waiver of sovereign immunity under Section 106(a)(1) allows a trustee to file a derivative suit against the IRS for receipt of a state-law fraudulent transfer under Section 544(b)(1). To read ABI’s report, [click here](about:blank).

The Ninth Circuit had split with a Seventh Circuit opinion rendered three years earlier, In re Equipment Acquisition Resources Inc., 742 F.3d 743 (7th Cir. 2014). The Chicago-based appeals court had reasoned that the waiver of immunity does not extend to Section 544(b)(1) suits because any actual creditor would have been barred from suing by the government’s sovereign immunity.

The same issue is coming up in the Tenth Circuit from a district court decision in favor of the trustee finding a waiver of sovereign immunity.

Same Facts as *DSBI*

A corporation filed a chapter 11 petition in 2017. The case was converted to chapter 7.

More than three years before bankruptcy, the corporation had paid the IRS about $150,000, representing tax liabilities for two individuals who were officers, directors and shareholders of the debtor corporation.

Utilizing Section 544(b)(1), the chapter 7 trustee sued the IRS to recover the payments as fraudulent transfers under Utah’s version of the Uniform Fraudulent Transfer Act.

The IRS agreed that the debtor corporation received no value and that the debtor was insolvent at the time of the transfer. The IRS also conceded there was an unsecured creditor in existence at the time who still held an allowable claim at the time of bankruptcy, to supply the requirement of an actual creditor under Section 544(b)(1).

The IRS argued, however, that no actual creditor could exist because any actual creditor would be barred from suing the government under the doctrine of sovereign immunity.

Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled in favor of the trustee on motion for summary judgment. *Miller v. United States (In re All Resort Group Inc.)*, 617 B.R. 375 (Bankr. D. Utah 2020).

The IRS appealed but lost again in an opinion on September 8 by District Judge Bruce S. Jenkins.

Judge Jenkins adopted Bankruptcy Judge Mosier’s memorandum decision and order and affirmed “for the reasons set forth” by Judge Mosier.

We shall therefore discuss the opinion by Judge Mosier. To read Judge Mosier’s opinion in full text, [click here](about:blank).

Same Facts as *DBSI*

The circumstances before Judges Mosier and Jenkins were the same as in *DBSI*, except that the IRS was held liable in the Ninth Circuit where the stakes were larger. In *DBSI*, the IRS was nailed for $17 million in fraudulent transfers resulting from tax payments made by a corporation on behalf of shareholders. In the Utah case, the trustee was only after $150,000.

After losing in the Ninth Circuit, the IRS twice sought and obtained extensions of time from the Supreme Court for filing a petition for *certiorari* that would have raised the split with the Seventh Circuit. Ultimately, either the IRS or the U.S. Solicitor General decided against filing a ‘*cert*’ petition.

The IRS was represented before District Judge Jenkins by attorneys from the Tax Division of the Justice Department in Washington. With comparatively few dollars in the balance, it’s a reasonable assumption that the IRS will appeal to the Tenth Circuit, aiming for a result like the Seventh Circuit’s.

Win or lose, an enlarging circuit split may spin off a petition for *certiorari* to come before the Supreme Court in the term to begin in October 2022.

The Arguments on Sovereign Immunity

The Bankruptcy Code of 1978 contained a waiver of sovereign immunity, but the Supreme Court held that the waiver was not “unequivocally expressed.” *United States v. Nordic Village Inc.,* 503 U.S. 30, 33. (1992). Congress legislatively overruled *Nordic Village* in the Bankruptcy Reform Act of 1994 by rewriting Section 106(a) entirely and listing 59 sections of the Bankruptcy Court as to which sovereign immunity was “abrogated as to a governmental unit.”

Section 544 is one of the listed sections.

Judge Mosier acknowledged the spilt among the circuits and among lower courts with regard to the waiver of immunity for state-law claims under Section 544(b). He framed the question as whether the waiver extends to claims under state law.

Further complicating the question, the trustee admitted that sovereign immunity would have barred the “actual” creditor from suing the IRS if there were no bankruptcy. In other words, could there be an actual creditor to satisfy the requirement in Section 544(b) if no actual creditor could have sued successfully before bankruptcy?

Judge Mosier held that “the plain text of § 106(a)(l) unequivocally abrogates sovereign immunity as to the underlying state law cause of action.” The statute, he said, “contains no exceptions, qualifiers or carve-outs in its language.”

Regarding the disability of the actual creditor to sue the IRS on its own, Judge Mosier said it has no bearing on the availability of that defense against a trustee insidebankruptcy.

Judge Mosier buttressed his conclusion by legislative history and the “goal of estate maximization.”

Preemption

The IRS made a second argument: federal “field” preemption.

The IRS Code would not allow someone to sue the IRS to recover funds voluntarily paid by someone else. The IRS therefore argued that Utah fraudulent transfer law intruded into an area exclusively controlled by federal law.

Judge Mosier saw no federal preemption. To begin with, the trustee’s claim was under federal law, namely Section 544(b). Second, the trustee was not aiming to recover a tax payment. The trustee was after a fraudulent transfer.

Judge Mosier granted the trustee’s motion for summary judgment and denied the IRS’s cross-motion for summary judgment. He held that “§ 106(a)( 1) unequivocally waives the federal government's sovereign immunity with respect to the underlying state law causes of action incorporated through § 544(b) and that the IRC does not preempt such claims.”

[The district court’s opinion is](about:blank) *U.S. v. Miller*, 20-00248 (D. Utah Sept. 8, 2021).

#### Hounding a debtor for payment and shortening credit terms defeated an ‘ordinary course’ defense to a preference.

# Supplier Socked for $3.5 Million in Preferences Although All Bills Were Paid on Time

Even though the debtor paid its bills on time, a supplier who hounded the debtor for payment may be unable to prove the “ordinary course” defense and can be liable for a preference, as shown in an opinion by Chief Bankruptcy Judge Jeffrey J. Graham of Indianapolis.

As Judge Graham said in his January 13 opinion, a supplier may not have the ordinary course defense if the evidence shows that the debtor “prioritized paying [the preference defendant] over other creditors.”

Trial counsel for plaintiffs and defendants in preference suits should read Judge Graham’s opinion in full text for tips on the more effective evidence to be introduced at trial.

The time for appeal has not begun to run because Judge Graham is yet to rule on the amount of prejudgment interest. If there are one or more appeals, the outcome will indicate whether a supplier can be liable for a preference, even though payments were never late.

The ‘Ordinary Course’ Defense

The debtor was a 220-store appliance and electronics retailer. The supplier was one of the debtor’s primary providers of consumer electronics and the sole supplier of some products. The debtor’s same-store sales began declining about three years before the chapter 11 filing.

The creditors’ committee was given the right to pursue preferences. The committee sued the supplier for about $4.7 million in preferences received in the three months before filing. On summary judgment, the committee had established all of the elements of a preference under Section 547(b). Disputed facts precluded summary judgment on the supplier’s “ordinary course” defense.

Judge Graham held a trial regarding the “ordinary course” defense under Section 547(c)(2). The subsection gives the supplier a defense:

to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; *or*

(B) made according to ordinary business terms. [Emphasis added. Note the word “or,” making “A” and “B” disjunctive.]

Judge Graham meticulously recited the trial testimony about the ordinary course defense. We shall mention only a few pivotal facts.

Three years before bankruptcy, the debtor’s credit limit with the supplier was $12 million. Over the ensuing years, the supplier reduced the credit limit until it was $1 million. So the debtor could purchase $2 million in goods a month, the supplier gave the debtor 15-day terms. Leading up to bankruptcy, the debtor increased its purchases from the supplier because other suppliers were restricting or cutting off credit.

When the debtor filed bankruptcy, the supplier had been paid in full. In fact, the supplier paid the debtor $365,000 after filing on account of vendor credits.

The supplier did not file a claim but consented to permitting the bankruptcy court to enter final judgment.

The Tests for ‘Ordinary Course’

Judge Graham laid out the law on what he referred to as the “subjective” ordinary course defense, where the supplier shoulders the burden of proof by a preponderance of the evidence. The supplier, he said, must establish a “baseline of dealing” to show whether the payments were “consistent with the parties’ practice before the preference period.” The testing period, he said, should be based on a time when the debtor “was financially healthy.”

For the testing period, Judge Graham eliminated the 15 months before the chapter 11 filing when the debtor was in financial distress. The limitation didn’t matter, he said, because 98% of the invoices within the preference period were paid either before or within the required 15 days of invoicing.

Judge Graham therefore found that the payments in the preference period “remained consistent” with payments in the testing period. He found other facts in favor of the supplier. For example, the supplier never (1) withheld shipments, (2) sought personal guarantees, (3) threatened to turn the receivables over to a collection agent, or (4) threatened litigation.  
  
Still, the supplier was unable to prove the defense by a preponderance of the evidence because (a) the supplier “consistently” sought payment by communicating “frequently” with the debtor’s senior management, (b) the supplier threatened to withhold shipments if payments were not made, (c) the debtor’s employees “advocated” for payment to the supplier because they “valued their relationship” with the supplier, and (d) the supplier “significantly” reduced the debtor’s credit to $1 million “at a time when the Debtor’s business with [the supplier] was at an all-time high.”

Judge Graham said the outcome was “not an easy call.” The evidence on both sides was in balance. He tipped the scale in favor of the debtor in view of the supplier’s “concerted effort to limit [its] exposure,” the significant reduction in the credit limit, and the supplier’s frequent communications seeking payment.

The facts led Judge Graham to the “inescapable conclusion” that the debtor “prioritized paying [the supplier] over other creditors. And this is what Congress meant to remedy when drafting Section 547(b).”

Because the supplier failed to prove the defense by a preponderance of the evidence, Judge Graham gave the debtor a judgment for a net preference of about $3.5 million, given the supplier’s $1.2 million offset for new value.

Observations

Is there anything wrong with this picture?

The supplier provided badly needed goods when other suppliers would not. For vigilantly policing the receivables, the supplier was slapped with a $3.5 million preference judgment.

When a debtor’s finances are precarious, should suppliers be at risk of receiving preferences for restricting credit terms, even though the debtor pays on time?

Section 547 was designed to encourage suppliers to deal with companies in financial distress. Should suppliers be liable for hounding debtors for payment, or should suppliers remain silent and cut debtors off when they don’t pay?

The foregoing are policy considerations, which don’t matter much these days. The statute matters.

In terms of the statute, hounding the debtor for payments may not be in the ordinary course of business between the two parties, but did the supplier nonetheless qualify for the defense under Section 547(c)(2)(B)?

The credit terms were 15 days, and the debtor always paid within 15 days. Are 15 days not “ordinary business terms” for a retailer in financial distress? Were the terms not ordinary because the supplier hounded the debtor for payment?

[The opinion is](https://abi-opinions.s3.amazonaws.com/HHGregg.pdf) *Official Committee of Unsecured Creditors of Gregg Appliance Inc. v. D&H Distributing Co. (In re HHGregg Inc.)*, 17-50282 (Bankr. S.D. Ind. Jan. 13, 2022).

#### The ‘average-lateness’ test reveals payments that were not made in the ‘ordinary course.’

# Ordinary Course Defense Works When the Supplier Doesn’t ‘Hound’ for Payment

Yesterday, we analyzed a case where hounding a debtor for payment and shortening credit terms defeated the “ordinary course” defense and saddled the supplier with a $3.5 million preference judgment, even though none of the payments was late.

Today, we review an “ordinary course” opinion by Bankruptcy Judge Robert E. Grossman where there was no unusual collection activity, the suppliers did not know the debtor was in financial trouble, and the suppliers did not pressure the debtor to pay during the so-called 90-day preference period before bankruptcy.

Judge Grossman, of Central Islip, N.Y., upheld the “ordinary course” defense under Section 547(c)(2)(A) and dismissed a passel of preference complaints on summary judgment.

After confirmation of a chapter 11 plan, the trustee of a creditor’s trust sued several suppliers for a preference. For simplicity, we shall refer to the plan trustee as the debtor.

Previously, Judge Grossman ruled on motions for partial summary judgment that the debtor had established all of the elements of a preference under Section 547(b). In his February 3 opinion, Judge Grossman reviewed the undisputed facts about the debtor’s payment history to apply the “ordinary course” defense under Section 547(c)(2)(A).

Section 547(c)(2) gives the supplier a defense:

to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or

(B) made according to ordinary business terms.

Citing the *Collier* treatise, Judge Grossman said that Section 547(c)(2)(A) is a subjective test designed to protect customary credit transactions paid in the ordinary course of business of the debtor and the supplier. He said that the defense provides “a level of predictability so that suppliers such as the Defendants are permitted to keep payments that would otherwise be deemed preferences.”

Citing legislative history, Judge Grossman said that Congress intended for the defense to discourage “unusual activity” by either the debtor or creditors in the slide toward bankruptcy.

All of the suppliers in the cases before him had been dealing with the debtor for years and had scores of transactions among them.

In reviewing credit history, Judge Grossman said there are two predominant tests: the average-lateness method and the total-range method. The former compares the average days to pay in the pre-preference period to those in the preference period.

The total-range method comes into play if the averages are skewed by “outliers.” Under the “total range of payments” test, Judge Grossman said:

[T]the Court reviews all of the payments made during the Baseline Period (which is agreed by all parties as the two years prior to the 90-day preference period) and determines the range of payments from the earliest to the latest. If the payments made during the preference period fit within the range, they are protected by the ordinary course of business defense. If the Court finds that the range of payments during the Baseline Period is too broad, the Court may adopt the bucketing analysis. Under the bucketing analysis, the Court reviews the payments made during the baseline period and groups them into buckets by age, then applies an appropriately sized bucket to the preference period payments to determine what is ordinary and what is not. As this Court previously stated, a range from the Baseline Period that captures around 80% of the payments would be an appropriate size bucket. [Citation omitted.]

Judge Grossman sided with the suppliers and decided to apply the average-lateness test, because it “is more likely to ‘weed out’ payments that could skew the analysis.”

In the cases before him, the average lateness in the two years before the preference period ranged between 39 and 47 days. In the preference period, payments ranged between four days early to seven days late.

Judge Grossman cited the Seventh and Eighth Circuits for holding that deviations of five to seven days from the pre-bankruptcy average were not enough to deprive the supplier of the defense. In the cases before him, he saw no reason to go beyond the average-lateness test to uphold the suppliers’ defenses.

Had he employed the bucketing analysis, the result would be the same, Judge Grossman said. Eighty-two percent of the payments before the preference period would encompass all but one of the payments made in the preference period. In the case of that one payment, it was also covered by the new value defense.

Judge Grossman gave judgment to the suppliers on the preference claims. The debtor also had lodged fraudulent transfer claims.

Judge Grossman dismissed the fraudulent transfer claims because the allowance of the ordinary course defenses established that the suppliers had provided reasonably equivalent value.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Decor+Holdings.pdf) *Ryniker v. Bravo Fabrics Inc. (In re Décor Holdings Inc.)*, 20-08125 (Bankr. E.D.N.Y. Feb. 3, 2022).

#### Fifth Circuit opinion shows that disallowance of a class proof of claim may preclude individual class members from filing late claims.

# No ‘Excusable Neglect’ for Late Claim if Class Claim Was Denied, Fifth Circuit Says

If a class has not been certified before bankruptcy, every member of the class should file an individual proof of claim before the bar date. That’s the practice point gleaned from a Fifth Circuit opinion on March 10.

If the class is so numerous that individual claims are not practicable, the opinion by Circuit Judge Edith Brown Clement counsels the attorney for the class to file a motion in bankruptcy court for authority to file a class claim, followed by a motion in bankruptcy court to approve the class.

Why go to so much trouble? Easy answer: The bankruptcy court may not approve a class claim, and a court like the Fifth Circuit might not allow individual claims after the bar date.

The Two-Year, Nine-Month Delay in Filing Individual Claims

On behalf of a class of about 100 former employees, two plaintiffs filed a wages and hours class action before the employer’s bankruptcy. Also before bankruptcy, the district court refused to enforce an arbitration clause. The employer appealed to the Ninth Circuit.

While the appeal was pending, the employer filed a chapter 11 petition and served a bar-date notice on each of the 100 former employees in the class. The named plaintiffs filed a $14 million proof of claim for the class, which had not been certified in any court.

Almost 30 class members filed individual claims before the bar date. The remaining 70 did not file claims. Before confirmation of the chapter 11 plan, the debtor signaled its intention to object to the class claim.

After modification of the automatic stay, the Ninth Circuit reversed the district court and directed that the wages and hours claims be arbitrated. As Judge Clement said, enforcing arbitration effectively disallowed the class claim and meant “that all claims by the purported ‘class’ members had to be arbitrated individually.”

Only then, two years and nine months after the bar date, did the 70-some former workers file individual proofs of claim accompanied by a motion to allow late-filed claims for “excusable neglect.” The bankruptcy court refused to allow the late-filed claims, but the district court reversed.

The Fifth Circuit reversed the district court and reinstated the bankruptcy court’s disallowance of the late-filed claims.

Disallowing Late Claims Wasn’t an Abuse of Discretion

The outcome of the appeal was governed by Supreme Court precedent laying out four factors to consider when deciding whether there was excusable neglect. *See* *Pioneer* *Investment Services Co. v. Brunswick Associates Ltd. Partnership*, 507 U.S. 380 (1993).

Although some circuits have held that one factor is more important than the others, Judge Clement said that the Fifth Circuit has not made any factor dominant. She reviewed the bankruptcy court’s excusable-neglect decision for what she called the “exceptionally deferential” abuse of discretion standard.

The first *Pioneer* factor considers the danger of prejudice to the debtor. The bankruptcy court had found in favor of the debtor, but Judge Clement disagreed.

The debtor had notice of the wages and hours claims long before bankruptcy and “that they might ultimately be allowed in the bankruptcy proceeding,” Judge Clement said. In addition, the plan had a disputed-claims reserve. The first factor “cuts in favor of the Claimants here,” she said.

The second *Pioneer* factor considers the length of delay and the impact on judicial proceedings if creditors could file late claims. The bankruptcy court decided that the second factor favored the debtor, and Judge Clement agreed.

The debtor’s knowledge of the claims before confirmation “does not mean that they expected to have to resolve those claims even if they were filed *late*,” Judge Clement said. [Emphasis in original.]

Moreover, the claimants’ counsel presented no evidence to the bankruptcy court regarding the impact on judicial proceedings. Even if the circuit court were to consider the claimants’ argument, Judge Clement said “it permits the reasonable inference that the delay that would result from allowing [approximately 70] additional arbitrations to proceed could significantly impact the resolution of the wage litigation and bankruptcy.”

Judge Clement agreed with the bankruptcy court that the length-of-delay factor favored the debtor.

The reason for the delay is the third *Pioneer* factor.

Judge Clement said that courts are “less likely to find excusable neglect when the reason for the delay was within the movant’s reasonable control.” She said that the claimants had notice that the debtor would object to the class claim, but they did not protect themselves, even though all 70 had notice of the bar date.

In other words, the “Claimants took a risk that a class proof of claim would be allowed; that risk did not pan out for the Claimants, and the Debtors are not responsible for the consequences that followed,” Judge Clement said.

The third factor focuses on whether the failure to perform on time was “beyond the reasonable control” of the party seeking an extension of time, according to Judge Clement. In the case at hand, she said, “Most of what caused the delay in this case was not beyond the reasonable control of the Claimants, whose duty it was to file timely proofs of claim.”

Judge Clement agreed with the bankruptcy court’s finding that the third factor favored the debtor.

The fourth *Pioneer* factor weighs the claimants’ good faith. In that respect, Judge Clement noted the bankruptcy court’s observation that the action of the claimants’ counsel “verged on malpractice.” She said that “counsel’s failure to act diligently throughout the bankruptcy proceeding was so severe that it undermines their argument that they acted in good faith.”

Specifically, Judge Clement said that the claimants’ counsel’s failure to invoke Federal Rule 23 in the bankruptcy case “evinces both a severe lack of diligence and a misunderstanding of bankruptcy procedural rules.” In that regard, she noted that the Fifth Circuit is yet to rule on whether a class claim is even permitted in bankruptcy.

Judge Clement agreed with the bankruptcy court: Good faith favored the debtor.

Even though one of the four factors favored the claimants, Judge Clement reversed the district court because she could not “say that the bankruptcy court abused its discretion by denying the Claimants’ motion for relief from the bar date.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/CJ+Holding.pdf) *West Wilmington Oil Field Claimants v. Nabors Corporate Services Inc. (In re CJ Holding Co.)*, 21-20394 (5th Cir. March 10, 2022).

#### The transfer of title in a real estate foreclosure is not a transfer on account of an antecedent debt and therefore can’t be a preference, at least in Florida.

# Judge Isicoff Explains Why a Foreclosure Sale Can’t Be a Preference

Although some courts reach the same result for different reasons, Bankruptcy Judge Laurel M. Isicoff of Miami explained why a mortgage foreclosure cannot be a preference in Florida.

In short, there is no payment of antecedent debt.

A homeowner defaulted on a $150,000 mortgage. The lender went through the steps required in Florida to take title through a credit bid: The lender filed a foreclosure complaint; the state court entered a final judgment of foreclosure; the lender was the successful bidder at the foreclosure sale with a $69,000 credit bid; a certificate of sale was entered; and after the homeowner unsuccessfully objected to the sale, the state court issued a certificate of title.

The same day the state court overruled the objection and said it would issue a certificate of title, the homeowner filed a chapter 13 petition and immediately filed a complaint to set aside the foreclosure sale as a preference under Section 547. The lender filed a motion to dismiss, contending that the complaint failed to state a claim.

The lender conceded that the home had been property of the debtor and that the debtor was insolvent in the 90 days before bankruptcy.

In her November 10 opinion, Judge Isicoff listed the two remaining questions: (1) Was the transfer on account of an antecedent debt; and (2) did the lender receive more than it would have in chapter 7?

The debtor argued that the transfer of the home to the lender was on account of the lender’s status as a creditor and was therefore on account of antecedent debt.

Some courts, Judge Isicoff said, believe that the first transfer in foreclosure is a transfer to the lender that can be set aside as a preference if the lender recovers more than it would in a hypothetical liquidation. Other courts, according to Judge Isicoff, believe that a foreclosure sale is not on account of antecedent debt.

In Florida, a foreclosure entails two transfers, Judge Isicoff said. The first transfer is the issuance of the certificate of title. The payment of the sale proceeds to the foreclosing lender is the second transfer.

In Florida, though, lenders are entitled to credit bid, to avoid requiring the lender to pay cash that will be repaid to the lender almost immediately. Consequently, the transfer to the lender at a foreclosure sale “is in consideration of the payment of the bid amount,” Judge Isicoff said.

Judge Isicoff explained how foreclosure works and where the transfers are found:

[T]he transfer to [the lender] on account of the antecedent debt was the transfer of the sale proceeds (had there been sale proceeds) to [the lender]. The issuance of the certificate of sale to [the lender] was not on account of the antecedent debt, but rather on account of [the lender’s] payment of the purchase price, which, in this case, was done by the credit bid.

Therefore, the lender received title in its capacity as a purchaser, not as a creditor, Judge Isicoff explained. As a result, the foreclosure sale could not be avoided as a preference because there was no transfer on account of antecedent debt.

Because one of the elements of a preference was not present, Judge Isicoff was not required to decide whether the lender received more than it would in chapter 7.

In a footnote, Judge Isicoff said she believes that *BFP v. Resolution Trust*, 511 U.S. 531 (1994), is not applicable to preferences. The Supreme Court held in *BFP* that a regularly conducted mortgage foreclosure cannot be set aside as a fraudulent transfer.

Under Florida law, the amount bid at a foreclosure sale is “conclusively presumed” to be sufficient consideration. On that basis, Judge Isicoff said she also would have granted the lender’s motion to dismiss.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Nunez.pdf) *Nunez v. Wilmington Savings Fund Society (In re Nunez)*, 21-01157 (Bankr. S.D. Fla. Nov. 10, 2021).

### Sales

#### To be a good faith purchaser under Section 363(m), a purchaser must be given actual notice to those with an interest in the property. Constructive notice won’t suffice.

# Constructive Notice Won’t Save a Sale Under 363(m) Absent Actual Notice, Circuit Says

Even if a creditor had constitutionally adequate constructive notice of a bankruptcy sale, the Seventh Circuit is saying that the buyer will not be in good faith and will not have protection from Section 363(m) if the buyer knew about a creditor’s interest in the property but did not give actual notice.

Three years before bankruptcy, the creditor was given a right of first refusal to buy the debtor’s real property. The ROFR was recorded with the land records.

In chapter 11, the debtor did not schedule the ROFR. Alongside a confirmed chapter 11 plan, Bankruptcy Judge Susan V. Kelley, now retired, approved the sale of the property free and clear of all liens, claims and encumbrances. No one told her about the ROFR.

According to the April 4 opinion for the Seventh Circuit by Circuit Judge Frank H. Easterbrook, the buyer evidently had run a title search and had a copy of the ROFR before the bankruptcy sale.

Although the debtor obviously knew about the ROFR, neither the debtor nor the buyer gave the creditor actual notice of the bankruptcy or the sale. In fact, Judge Easterbrook said that the buyer did not give notice to the creditor even after the creditor’s lawyer inquired about one week before the pending sale.

In other words, the creditor might have had constitutionally adequate constructive notice of the sale but was not given actual notice.

Four years after the chapter 11 sale, the buyer resold the property to a third party. The creditor responded with a suit in state court seeking damages from the original buyer for disregarding the ROFR.

The original buyer returned to bankruptcy court, aiming to enforce the “free and clear” aspects of the sale. Bankruptcy Judge Kelley refused to enjoin the suit in state court under Section 363(m), and the district court affirmed. *See* *Archer-Daniels Midland Co. v. Country Visions Cooperative*, 628 B.R. 315 (E.D. Wis. Feb. 19, 2021). To read ABI’s report on the district court affirmance, [click here](https://www.abi.org/newsroom/daily-wire/espinosa-doesn%E2%80%99t-forgive-all-procedural-defects-in-confirmation-judge-ludwig).

On appeal to the Seventh Circuit, Judge Easterbrook said that the parties “devoted a lot of time and space” to the question of whether the creditor had sufficient notice before the 2011 sale to comply with the Fifth Amendment requirement of constitutionally adequate notice.

“We do not address that subject,” Judge Easterbrook said, “because statutory questions [under Section 363(m)] precede constitutional ones.” The section says,

The reversal or modification on appeal of . . . a sale . . . of property does not affect the validity of a sale . . . to an entity that purchased . . . such property in good faith . . . .

If the buyer “did not buy the parcel in ‘good faith’ in 2011,” Judge Easterbrook said, “it loses no matter what the Constitution has to say about the sort of notice [that the creditor] should have received.”

Turning to the facts, Judge Easterbrook said it was “clear” that the debtor “proceeded in bad faith” by not giving notice to the creditor. However, he said that the “question is whether [the buyer] bought the parcel in good faith, not whether the [debtor] sold it in bad faith.”

Still, Judge Easterbrook could not resist adding *dicta* when he said, “If anyone should be made to compensate [the creditor], it is the [debtor’s two principals].”

Turning to the responsibility of the buyer, Judge Easterbrook noted that the buyer had constructive notice of the ROFR by the real estate recording and actual notice by possession of the title search.

Judge Easterbrook therefore found it “impossible to disagree” with the two lower courts that “someone who has both actual and constructive knowledge of a competing interest, yet permits the sale to proceed without seeking the judge’s assurance that the competing interest-holder may be excluded from the proceedings, is not acting in good faith.”

Judge Easterbrook affirmed the lower courts, saying, “Good-faith purchasers enjoy strong protection under §363(m). But [the buyer] is not a good-faith purchaser. It must defend the state litigation.”

Observation

This is an important decision. It could be cited for the following proposition:

A buyer will not be in good faith under Section 363(m) if the buyer does not give written notice required by the Bankruptcy Code and Rules to someone with an interest in the property being sold. The buyer is not in good faith even if the holder of the interest knew about the bankruptcy or the sale.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Archer+Daniels.pdf) *Archer-Daniels Midland Co. v. Country Visions Cooperative*, 21-1400 (7th Cir. April 4, 2022).

### Small Biz. Reorg. Act

#### Both individuals and corporations in subchapter V of chapter 11 are barred from discharging debts that are nondischargeable under Section 523(a).

# Corporate Debtors in Subchapter V Can’t Discharge Nondischargeable Debts, Circuit Says

Debts that are nondischargeable as to *individuals* under Section 523(a) cannot be discharged by *corporate debtors* in Subchapter V of chapter 11, according to the Fourth Circuit.

Resolving what it called a “close” question, the Fourth Circuit believes that “fairness and equity” require making the debts nondischargeable since a small business debtor in Subchapter V has an easier road to confirmation given the absence of the absolute priority rule.

Corporations saddled with debts that would be nondischargeable under Section 523(a) must undergo the rigors of an “ordinary” chapter 11 case to discharge those debts, if the Fourth Circuit’s opinion is accepted nationwide.

The Judgment for Willful and Malicious Injury

A creditor won a $4.7 million judgment in state court for tortious interference with contract. More specifically, the jury found that the debtor had stolen customer information from the creditor.

The debtor filed a small business petition under Subchapter V of chapter 11, intending to discharge the judgment under Section 1192. The plan would have paid the creditor about 3% of its claim over five years.

Asserting that the judgment was not dischargeable under Section 523(a)(6) as a “willful and malicious” injury to its property, the creditor filed a complaint seeking a declaration that the judgment would not be discharged under Section 1192(2).

Deciding that the debt was dischargeable, the bankruptcy court dismissed the complaint in what Circuit Judge Paul V. Niemeyer called a “nicely crafted opinion.” The bankruptcy court authorized a direct appeal, which the Fourth Circuit accepted.

The ‘Discordant’ Statutes

The appeal called for an interpretation of two statutes which Judge Niemeyer called “a bit discordant — or perhaps more accurately, clumsy.”

Applicable only in Subchapter V cases, Section 1192 discharges debts, “except any debt . . . (2) of the kind specified in section 523(a) of this title.”

Section 523(a) provides that a “discharge under section . . . 1192 . . . does not discharge an individual debtor from any debt . . . (6) for willful and malicious injury by the debtor to another entity or to the property of another entity.”

In his June 7 opinion, Judge Niemeyer relied on a “textual review” along with “practical and equitable considerations” in holding that the debt was nondischargeable in Subchapter V despite “a certain lack of clarity in the relationship between § 1192(2) and § 523(a).”

Textual Analysis and Policy

Before focusing on dischargeability, Judge Niemeyer said that one of the “main features” of Subchapter V is the elimination of the absolute priority rule that otherwise governs confirmation of chapter 11 plans. It enables “the owners of a Subchapter V debtor . . . to retain their equity in the bankruptcy estate despite creditors’ objections,” he said.

Turning to dischargeability and focusing on Section 1192(2) alone, Judge Niemeyer said it “provides for the discharge of debts for *both* individual and corporate debtors.” [Emphasis in original.]

“Still,” Judge Niemeyer said, the question remains “whether the exception to such discharges — based on § 1192(2)’s reference to § 523(a) — applies to both individuals and corporations or to only individuals.”

To answer the question, Judge Niemeyer focused on Section 1192(2) because it “specifically” governs dischargeability in Subchapter V. He paraphrased the section by saying it excepts from discharge “‘any *debt . . . of the kind* specified in section 523(a).’” [Emphasis in original]. To his way of thinking, the use of the word “debt” was “decisive, as it does not lend itself to encompass the ‘kind’ of *debtors* discussed in the language of § 523(a).” [Emphasis in original.]

Judge Niemeyer concluded that “the combination of the terms ‘debt’ and ‘of the kind’ indicates that Congress intended to reference only the *list of nondischargeable debts* found in § 523(a).” [Emphasis in original.] He said that use of the words “of the kind” was statutory “shorthand to avoid listing all 21 types of debts.”

Judge Niemeyer held that “*the debtors* covered by the discharge language of § 1192(2) — *i.e.*, both individual and corporate debtors — remain subject to the 21 *kinds of debt* listed in § 523(a).” [Emphasis in original.] He was persuaded in part by the idea that the specific governs the general.

Having construed the statutory language alone, Judge Niemeyer looked at similar provisions in the Code. He said it would be difficult to reconcile Section 523(a) with Section 1141(d)(6).

Judge Niemeyer also referred to Section 1228(a) of chapter 12 and its language “that is virtually identical” to Section 1192(2). Section 1228(a), he said, has been interpreted by two bankruptcy courts to mean that exceptions to discharge apply to both individual and corporate debtors.

Judge Niemeyer ended his opinion by discussing “fairness and equity” and the ability of a chapter 12 debtor to confirm a cramdown plan without satisfying the absolute priority rule. He said that “Congress understandably applied limitations on the discharge of debts to provide an additional layer of fairness and equity to creditors to balance against the altered order of priority that favors the debtor.”

Reversing and remanding, Judge Niemeyer said that a small business debtor “should not especially benefit from the discharge of debts incurred in circumstances of fraud, willful and malicious injury, and the other violations of public policy reflected in § 523(a)’s list of exceptions” when that debtor is immune from the absolute priority rule.

Questions

Congress decided to make virtually all debts dischargeable in chapter 11 because a finding of nondischargeability would injure the greater body of creditors. Similarly, Congress created Subchapter V because the rigors and expense of traditional chapter 11 was hurting creditors as well as the owners of small businesses.

Given the history and tradition of broad dischargeability in chapter 11, is the language in Section 1192 sufficiently clear to swim against the tide? Is the plain meaning of Section 523(a) overcome by the less than clear meaning of Section 1192(2)?

[The opinion is](https://abi-opinions.s3.amazonaws.com/Cleary+4th+cir.pdf) *Cantwell-Cleary Co. v. Clearly Packaging LLC (In re Cleary Packaging LLC)*, 21-1981 (4th Cir. June 7, 2022).

#### Unlike chapters 12 and 13, the bankruptcy court in Subchapter V has discretion in selecting the commitment period for confirmation of a cramdown plan.

# Sub V Has a Flexible Commitment Period in Cramdown, Ninth Circuit BAP Says

The statutory standards for confirming a cramdown plan under Subchapter V of chapter 11 are imprecise, if not downright vague. The Bankruptcy Appellate Panel for the Ninth Circuit has written an opinion “to explain the unique role” played by the bankruptcy court “to set the commitment period in which the debtor must pay its projected disposable income or its value.”

The debtor was a bail bond company that had been foundering in chapter 11 before the advent of Subchapter V in March 2020. To gain a new lease on life and avert dismissal, the debtor amended the petition to elect treatment under Subchapter V.

The Sub V Plan

Continuing to operate and hoping to remain in business indefinitely, the debtor sold a parcel of real property that the debtor had foreclosed after a criminal defendant skipped bail. The sale generated net proceeds of some $433,000.

In the three years after confirmation, the debtor estimated its net disposable income would be about $287,000. If it were a five-year period, the estimated net disposable income would be almost $500,000, the debtor said.

Most of the debt was held by one creditor, who had been persistently imploring Bankruptcy Judge Erithe A. Smith to dismiss the case.

With guidance from the Subchapter V trustee, the debtor proposed a plan that would pay the principal creditor $433,000 on confirmation. In addition, the plan committed the debtor to pay all of its disposable income to the principal creditor, whatever it might turn out to be.

The plan did not promise to pay a specific amount of net disposable income. For the debtor to obtain a discharge, the plan did oblige the debtor to pay the principal creditor at least an additional $181,000 above the payment on confirmation.

Creditors did not approve the plan, so the debtor was obliged to invoke cramdown. Naturally, the principal creditor opposed confirmation. Using cramdown, Judge Smith confirmed the plan nonetheless.

In his April 27 opinion for the BAP, Bankruptcy Judge Scott H. Gan upheld confirmation.

Flexible Rules on the Commitment Period

The appeal from the confirmation order called on the BAP to determine whether the cramdown plan satisfied the so-called fair and equitable test under Section 1191(b). The subsection requires the court to confirm the plan “if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”

Section 1191(c)(2) contains a unique definition of “fair and equitable” for the purposes of Subchapter V. Subsection (c)(2)(A) requires the plan to provide that:

all of the projected disposable income of the debtor to be received in the 3-year period, or such longer period not to exceed 5 years as the court may fix, . . . will be applied to make payments under the plan.

The plan did not comply with subsection (c)(2)(A), Judge Gan said, because it only promised a “possible payment of an unknown amount from Debtor’s actual disposable income.”

The plan was not doomed, however, because Section 1191(c)(2) permits a debtor to satisfy either subsection (c)(2)(A) or (c)(2)(B). Subsection (c)(2)(B) permits confirmation if:

the value of the property to be distributed under the plan in the 3-year period, or such longer period not to exceed 5 years as the court may fix, . . . is not less than the projected disposable income of the debtor.

For Judge Gan, “the record is clear” that the plan satisfied subsection (c)(2)(B) “because the effective date payment [of $433,000] is greater than Debtor’s projected disposable income for the minimum three-year period required by § 1191(c)(2).”

Judge Gan said that Subchapter V “sets a baseline requirement that a debtor commit three years of projected disposable income, while it also affords the bankruptcy court discretion to require more as a condition of finding a plan fair and equitable.”

The ability of the court to set a longer commitment period “is unique to subchapter V,” Judge Gan said. The commitment periods are fixed in chapters 13 and 12, he said.

“By giving the bankruptcy court the sole authority to require a longer commitment period in appropriate cases, subchapter V ensures an efficient confirmation process for small business debtors,” Judge Gan said.

To satisfy the minimum requirement of subsection (c)(2)(B), Judge Gan said that the plan must provide for payments in three years after confirmation “having a present value of not less than [the debtor’s estimate of some $287,000].”

Judge Gan held that the bankruptcy court did not err in finding the plan to be fair and equitable and in satisfaction of Section 1191(c)(2)(B) because “the Plan provides for distribution of the [sale proceeds] on the effective date in the amount of [about $433,000].”

Although the plan satisfied cramdown confirmation requirements with the initial payment of $433,000, Judge Gan noted that the debtor will not receive a discharge unless the later payments of disposable income end up totaling at least $181,000.

If the debtors’ “projections are as fanciful” as the objecting creditor argued, Judge Gan said that the debtor “may not receive a discharge,” even though it complied with confirmation requirements.

The BAP upheld the bankruptcy court’s other findings on issues such as good faith and affirmed the bankruptcy court’s confirmation of the plan.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Orange+County.pdf) *Legal Services Bureau Inc. v. Orange County Bail Bonds Inc. (In re Orange County Bail Bonds Inc.)*, 212-1086 (B.A.P. April 27, 2022).

#### Increasingly, courts are allowing defunct corporations to proceed under the SBRA while individual owners of defunct businesses aren’t being treated as small business debtors in chapter 11.

# Liquidating a Defunct Corporation Qualifies for the SBRA, Judge Lopez Says

Mopping up a defunct business qualifies a corporate debtor for liquidation under the flexible rules for chapter 11 laid down in the Small Business Reorganization Act, or SBRA.

According to Bankruptcy Judge Christopher M. Lopez of Houston, collecting accounts receivable and maintaining the physical assets qualify as being engaged in commercial activities, even when the historical business is no longer operating.

The Nonoperating Plant

The debtor owned and previously operated a facility that converted waste heat from a nearby plant into electricity and steam sold to other nearby plants. After disputes with its primary creditor and supplier of waste heat, the debtor halted operations. The debtor and its creditor were mired in litigation and arbitration when the debtor filed a chapter 11 petition and elected to be treated as a small business under the SBRA.

The debtor filed a chapter 11 plan to liquidate the assets, collect accounts receivable, prosecute claims and distribute proceeds to creditors.

The primary creditor and the U.S. Trustee objected to the SBRA election, because the debtor was no longer operating its historical business. Judge Lopez overruled the objection in his July 1 opinion and allowed the debtor corporation to continue as a small business.

Qualification Under the SBRA

The SBRA became effective in February 2020 and is codified primarily in Subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195. The issue before Judge Lopez arose under the definition of a “debtor” in Section 1182(1)(A), which “means a person engaged in commercial or business activities . . . .”

Although the quoted terms are not defined in the Bankruptcy Code, Judge Lopez applied the “plain meaning” of the words. He agreed with cases holding that “‘engaged in’ commercial or business activities means a debtor was actively participating in one of these activities on the petition date.” The word “commercial,” he said, means “‘of or relating to commerce.’”

Although the debtor was no longer producing and selling steam and electricity, Judge Lopez identified the following commercial activities: The company was

* Managed by two principals of its limited partner and employed an independent contractor;
* Litigating a multi-million-dollar lawsuit with its principal creditor;
* Collecting $160,000 in accounts receivable from its principal creditor;
* Maintaining its facilities;
* Working on a plan to pay creditors by selling assets with an estimated value of $3 million; and
* Filing reports and tax returns with state and federal authorities.

Judge Lopez held that pursuing litigation, collecting accounts receivable, selling assets and maintaining assets “are all commercial and business activities.”

The objectors argued that the debtor had no W-2 employees, but Judge Lopez said that “neither do many U.S. small businesses, and, regardless, that is not required under Section 1182(1)(A).” He said that the section “also does not require a debtor to maintain its core or historical business operations on the petition date.”

Contending that Subchapter V was not intended for liquidations, the objectors relied on the SBRA’s legislative history by saying it was designed to promote reorganizations. “But this does not change the outcome,” Judge Lopez said. The language of the statute is clear, leaving no room to consider legislative history. To the contrary, he noted how the SBRA permits the sale of a debtor’s assets.

Judge Lopez agreed with *In re Offer Space, LLC*, Case No. 20-27480, 2021 WL 1582625, at \*2 (Bankr. D. Utah Apr. 22, 2021), where Bankruptcy Judge William T. Thurman of Salt Lake City held that a debtor need not be operational so long as it had a bank account and was managing its few remaining assets. To read ABI’s report on *Offer Space*, [click here](https://www.abi.org/newsroom/daily-wire/corporations-are-more-likely-eligible-for-the-sbra-than-owners-of-defunct).

Judge Lopez distinguished and declined to follow two cases where *individuals* owned defunct businesses and were held ineligible for Subchapter V, even though their debts arose from the defunct business. He was referring to *In re Johnson*, 2021 WL 825156 (Bankr. N.D. Tex. Mar. 1, 2021); and *In re Thurmon*, 2020 WL 7249555 (Bankr. W.D. Mo. Dec. 8, 2020). To read ABI’s reports on those cases, click [here](https://www.abi.org/newsroom/daily-wire/split-grows-on-whether-a-subchapter-v-debtor-must-be-%E2%80%98currently%E2%80%99-engaged-in) and [here](https://www.abi.org/newsroom/daily-wire/courts-are-now-split-on-whether-a-subchapter-v-debtor-must-be-%E2%80%98currently%E2%80%99).

Unlike *Johnson* and *Thurmon*, where the debtors were individuals, the debtor before Judge Lopez was a corporation. He found that this debtor was “engaged in commercial or business activities,” overruled the objections and allowed the debtor to proceed under Subchapter V.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Port+Arthur+Steam.pdf) *In re Port Arthur Steam Energy LP*, 629 B.R. 233 (Bankr. S.D. Tex. July 1, 2021).

#### If a loan benefits both a debtor and someone else, the loan still may be included in counting whether the debt “arose from the commercial or business activities of the debtor.”

# To Count in Subchapter V, Loans Need Not Benefit Only the Small Business Debtor

Loans made to finance a leveraged buyout may be included in calculating eligibility for reorganization under Subchapter V of chapter 11, even if the loan also conferred benefits on the buyers, according to Bankruptcy Judge Thomas J. Catliota of Greenbelt, Md.

In his October 26 opinion, Judge Catliota said that Section 1182(1)(A) does not require “excluding debt that directly benefitted others,” such as the buyers in a leveraged buyout, or LBO.

The LBO Loans

Two individuals arranged to buy a corporation. To effect the purchase, the buyers formed a holding company of which they were the exclusive owners.

For the holding company to acquire the equity interests in the target corporation, a lender made three loans totaling $5.75 million. The target corporation (soon to be the chapter 11 debtor) was the borrower and pledged all of its assets.

The corporate borrower filed a chapter 11 petition and elected treatment as a small business debtor under Subsection V of chapter 11. The debtor listed debts of about $6.4 million.

The former owner (that is, the seller in the LBO) purchased a $500 claim to have status as a creditor. As a creditor, the former owner objected to the debtor’s eligibility to proceed as a small business debtor.

Must a Debt Benefit Only the Debtor?

The outcome of the objection was controlled by Section 1182(1)(A), which says that a small business debtor must be

a person engaged in commercial or business activities . . . that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

The creditor conceded that the debtor was a “person” with no more debt that the statute allows. The creditor also admitted that the loans were “commercial or business activities.”

However, the creditor argued that the $5.75 million in LBO loans could not be counted because they did not arise “from the commercial or business activities *of the debtor*.” [Emphasis added.] According to the creditor, the LBO loans primarily benefitted the two buyers in acquiring the corporate debtor.

Interpreting “the commercial or business activities of the debtor,” Judge Catliota said that “virtually” all courts “have applied a liberal construction of the phrase in keeping with the [Small Business Reorganization Act’s] purpose and the language of § 1182(1)(A).” He cited Bankruptcy Judge Thomas B. McNamara of Denver, who said in *In re Ikalowych*, 629 B.R. 261, 276 (Bankr. D. Colo. 2021), that the phrase is “exceptionally broad.” To read ABI’s report on *Ikalowych*, [click here](https://www.abi.org/newsroom/daily-wire/denver-judge-opens-the-sbra-door-wide-for-people-with-debt-from-failed-companies).

The creditor relied on *In re Ventura,* 615 B.R. 1 (Bankr. E.D.N.Y. 2020)*.* To read ABI’s report on *Ventura*, [click here](https://www.abi.org/newsroom/daily-wire/stripping-down-a-mortgage-on-a-mixed-use-property-under-the-sbra).

To Judge Catliota’s way of thinking, *Ventura* was inapposite. *Ventura* decided whether a debt was primarily a commercial or consumer debt under Section 101(8).

Judge Catliota said:

The primary purpose test is applied to resolve the binary question of whether a debt is commercial or consumer. A transaction can have both commercial and consumer attributes, and a court must determine whether it is one or the other by assessing why the debt was “primarily” incurred. § 101(8). The language of § 1182(1)(A) does not require, or even invite, this inquiry where the debt so clearly arose from the commercial or business activities of the debtor.

“Primacy,” Judge Catliota said, “is not included in the assessment once the debt is determined to be incurred through the debtor’s commercial or business activities.” The statute, he said, “does not require the court to dissect the various benefits obtained by all the parties and, for purposes of § 1182(1)(A), include only debt that is linked to a direct benefit obtained by a debtor, while excluding debt that directly benefitted others.”

Judge Catliota noted several benefits received by the debtor from the LBO loans. Among other things, he pointed to a $250,000 working capital loan and a covenant requiring $600,000 in working capital.

“It simply cannot be disputed,” Judge Catliota said, “that, under the ordinary, contemporary, common meaning of the phrase, the debt ‘arose from the commercial or business activities . . . of the debtor.’” He denied the objection to treatment under Subchapter V because the objection was “not consistent with the statutory language and ignores the substance of the transaction, including an assessment of the direct and indirect benefits the Debtor obtained.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Family+Friendly.pdf) *Lyons v. Family Friendly Contracting LLC (In re Family Friendly Contracting LLC)*, 21-14213 (Bankr. D. Md. Oct. 26, 2021).

##### Consumer Bankruptcy

### Discharge/Dischargeability

#### No circuit split: The Second Circuit agrees with the Fifth and Tenth Circuits that only a subset of private student loans is automatically nondischargeable.

# All Private Student Loans Are Not Excepted from Discharge, Second Circuit Holds

Employing emphatic language, the Second Circuit joined two other circuits by holding that all student loans are not excepted from discharge simply because they are student loans.

Technically speaking, the appeals court held that private student loans are not excepted from discharge under Section 523(a)(8)(A)(ii). The only subset of private student loans excepted automatically from discharge are those falling under Section 523(a)(8)(B).

As Circuit Judge Dennis Jacobs said in his July 15 opinion, a private loan is excepted from discharge under Section 523(a)(8)(B) only if it was “made to individuals attending eligible schools for certain qualified expenses.”

The Loans in the Class Action

The facts of the case explain the breadth of the holding.

A student took down about $12,500 in loans from a private lender in the course of obtaining an undergraduate degree. The loans were not made through the college’s financial aid office and were disbursed directly to the student’s bank account. The student alleged that the loans were not made solely to cover the cost of attendance.

Soon after college, the student filed a chapter 7 petition, listed the student loans among his debts and received a general discharge. Of course, the discharge order did not specify which debts were discharged and which were not.

As Judge Jacobs said, the lender hired a collection agent “to pester” the debtor. Assuming the loans had not been discharged, the debtor paid them off.

In 2017, the debtor reopened his bankruptcy case and filed a purported class action in bankruptcy court. According to Judge Jacobs, the debtor’s adversary proceeding alleged that the lender “employed a scheme of issuing dischargeable loans to unsophisticated student borrowers and then demanding repayment even after those loans are discharged in bankruptcy.”

The lender filed a motion to dismiss that was denied by Bankruptcy Judge Elizabeth S. Stong of Brooklyn, N.Y. The lender appealed, and the district court certified a direct appeal to the Second Circuit. The appeals court accepted the appeal.

No Circuit Split

The lender argued on appeal in the Second Circuit that Congress intended in Section 523(a)(8) to bar discharge of all private student loans. The Fifth and Tenth Circuits already disagreed. *See* *Crocker v. Navient Sols. LLC (In re Crocker)*, 941 F.3d 206 (5th Cir. 2019); and *McDaniel v. Navient Sols. LLC (In re McDaniel)*, 973 F.3d 1083 (10th Cir. 2020). To read ABI’s reports on those cases, click [here](https://www.abi.org/newsroom/daily-wire/discharge-is-enforceable-only-in-the-issuing-district-fifth-circuit-says) and [here](https://www.abi.org/newsroom/daily-wire/not-all-student-loans-are-nondischargeable-tenth-circuit-holds).

As the Second Circuit is wont to do, Judge Jacobs assigned little import to the circuits with which he would agree. He launched into his own analysis, which he defined as solely a question of statutory interpretation subject to *de novo* review. Indeed, he said that the “inquiry begins (and in this case ends) with the statutory text.”

The lender conceded that the loan could be nondischargeable only under Section 523(a)(8)(A)(ii), which makes a debt automatically nondischargeable if it was “an obligation to repay funds received as an educational benefit, scholarship, or stipend.”

Therefore, Judge Jacobs said, the debt would be excepted from discharge only if it was “an educational benefit,” a term not defined in the statute. On that point, the lender relied on a nonprecedential Second Circuit opinion that appears to say that a private loan is nondischargeable under Section 523(a)(8)(A)(ii).

Reflexively, Judge Jacobs said that his panel was not bound by a nonprecedential opinion. Furthermore, he said that the prior panel dealt with a different issue and “did not squarely take on the statutory interpretation question.”

Looking at the statutory language, Judge Jacobs said that the lender’s argument was “unsupported by plain meaning.” He quoted the Tenth Circuit for saying that “no normal speaker of English” would read the language as the lender urged. *McDaniel, supra*, 973 F.3d at 1096.

If Congress had intended to make all private loans nondischargeable, “it would not have done so in such stilted terms,” Judge Jacobs said. The statutory text “more naturally” coincides with “educational benefits that students may become obligated to repay, such as conditional grants.”

Notably, Section 523(a)(8)(A)(ii) does not use the word “loan” but is “sandwiched” between two other subjections that do use the word. Judge Jacobs surmised that the omission was “intentional.”

If the lender’s reading were law, Judge Jacobs said, “virtually all student loans” would be made nondischargeable under Section 523(a)(8)(A)(ii), leaving the other subjections with no work. He parsed the section’s history and concluded that the 2005 amendments to the Bankruptcy Code were not designed to make all student loans dischargeable.

The “more significant modification” in the 2005 amendments was the introduction of Section 523(a)(8)(B), Judge Jacobs said. That new subjection “excepts a subset of private loans,” namely “any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual.”

In other words, the lender was contending that Congress enacted Section 523(a)(8)(B) to preclude the discharge of a type of loans that were already excepted from discharge.

Judge Jacobs supported his reading of the statute with the canon of construction known as *noscitur a sociis*. He said that the rule “instructs us to cabin [the words ‘educational benefit’] such that its scope aligns with that of its listed companions — ‘scholarship’ and ‘stipend.’”

In that respect, Judge Jacobs said that “scholarship” and “stipend” are conditional grants not generally required to be repaid. The “defining characteristic” of a loan, “by contrast, is an unconditional obligation to pay it back.”

Judge Jacobs summarized the types of student loans that are discharged and those that are not. Nondischargeable debts in Section 523(a)(8)(A)(i) are “government and nonprofit-backed loans and educational benefit overpayments,” along with “private loans made to individuals attending eligible schools for certain qualified expenses” under Section 523(a)(8)(B).

The only nondischargeable obligations under Section 523(a)(8)(A)(ii) are “scholarships, stipends and conditional education grants,” not loans.

Judge Jacobs upheld denial of the lender’s motion to dismiss, holding that an educational benefit “is therefore best read to refer to conditional grant payments similar to scholarships and stipends.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Homaidan.pdf) *Homaidan v. Sallie Mae Inc.*, 20-1981 (2d Cir. July 15, 2021).

#### Bankruptcy Judge Eduardo Rodriguez explained why the Second Circuit was wrong in ruling that violators of Rule 3002.1 are only liable for compensatory damages.

# Texas Judge Disagrees with Second Circuit on Sanctions for Violating Rule 3002.1

Taking sides with the dissenter and disagreeing with the Second Circuit’s majority opinion on August 2, Bankruptcy Judge Eduardo Rodriguez from the Southern District of Texas held that a debtor can mount a claim for sanctions and punitive damages under Bankruptcy Rule 3002.1(i)(2) when a lender violates Rule 3002.1(b) and (c) by failing to give notice of changes in the payment, charges, fees and expenses claimed by a secured lender.

The facts were complex but boil down to this: A couple filed a chapter 13 petition in 2011 and confirmed a plan. The plan cured arrears on their home mortgage and called for the trustee to make monthly payments. Throughout, the debtors paid what the plan specified in terms of monthly mortgage payments.

The debtors completed their plan payments. The trustee issued a notice of plan completion, and the debtors received a discharge.

Rule 3002.1 Notices Not Given

As later revealed, the lender had changed the monthly payments three times during the life of the chapter 13 plan but never filed the notices required by Rule 3002.1(b) and (c).

After discharge, the lender began claiming the mortgage was in default and threatened foreclosure. To stop foreclosure, the debtors filed a second chapter 13 petition in 2020. The servicer filed a claim that included about $33,000 in arrears on the mortgage.

The debtors filed a complaint against the lender, making a plethora of claims. The adversary proceeding also objected to the claim on the mortgage.

Of principal significance for our story, the debtors sought monetary sanctions and punitive damages under Bankruptcy Rule 3002.1(i)(2) for failure to give the notices required by subparts (b) and (c) of the Rule.

The lender filed a motion to dismiss, claiming that the rule is procedural and does not give rise to a claim for damages. In large part, the lender relied on *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), rehearing and rehearing en banc *den*. Nov. 1, 2021. To read ABI’s report, [click here](about:blank).

The Second Circuit’s *Gravel* Decision

*Gravel* made two landmark holdings. First, all three circuit judges agreed that the standard in *Taggart v. Lorenzen*, 139 S. Ct. 1795 (2019), for violation of the automatic stay applies to all contempt citations in bankruptcy court. In *Taggart*, the Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an “objectively reasonable basis for concluding that the creditor’s conduct might be lawful under the discharge order.” *Id*. at 1801. To read ABI’s discussion of *Taggart*, [click here](about:blank).

Over a vigorous dissent, two circuit judges in *Gravel* held that bankruptcy courts may not impose contempt sanctions for violating Bankruptcy Rule 3002.1. Rather, the majority ruled that a debtor may only recover compensatory damages, which often will be nominal.

Judge Rodriguez Disagrees with *Gravel*

Judge Rodriguez opened his discussion of the lender’s Rule 3002.1 dismissal motion by laying out the requirements and purpose of the rule. It applies to claims secured by a mortgage on a debtor’s principal residence where the debtor or the trustee is making payments under a chapter 13 plan.

Within 21 days, Rule 3002.1(b) requires the lender to serve notice on the trustee, the debtor and the debtor’s counsel anytime there is a change in the payment. Rule 3002.1(c) similarly requires notice regarding fees, expenses and charges allegedly incurred by the debtor after filing.

If the lender has not given the required notices, Rule 3002.1(i) provides that the court may prevent the lender from presenting evidence about the omitted information or “award other appropriate relief, including reasonable expenses and attorney’s fees caused by the failure.”

The rule was adopted to obviate situations where debtors complete their plan payments, receive discharges and then face foreclosure on a mortgage allegedly in default throughout the chapter 13 case.

The lender argued that Rule 3002.1 is a procedural rule that does not give rise to a cause of action. Judge Rodriguez knocked down that and other arguments.

Judge Rodriguez said he was not required to decide whether the rule creates an independent cause of action because the “plain language” in subsection (i)(2) permits the court to award “other appropriate relief.” He therefore denied the motion to dismiss the claim for damages under (i)(2).

The sanction that the court could impose was a “different question,” Judge Rodriguez said.

The lender argued that the debtor could not pursue sanctions in the second chapter 13 case that occurred during the first chapter 13 case. Again, Judge Rodriguez disagreed.

Finding no cases on point, Judge Rodriguez observed that the lender’s failure to give notices during the first case was continuing to harm the debtors, because the failure to abide by the rules caused them to incur expenses and file the second chapter 13 case.

Judge Rodriguez therefore decided that the plaintiffs could raise a claim in the second case for shortcomings during the first case.

Next, Judge Rodriguez addressed *Gravel* and the debtors’ right to claim sanctions and punitive damages.

Judge Rodriguez Sides with the *Gravel* Dissenter

Judge Rodriguez explained why the Second Circuit majority concluded that Rule 3002.1 is limited to non-punitive sanctions. He quoted the dissenter who saw the rule’s plain meaning as giving the court discretion to impose punitive monetary sanctions.

If there were no possibility of punitive damages, Judge Rodriguez paraphrased the dissenter as saying that “mortgagees have little incentive to make the systemic changes required to service loans properly in chapter 13.”

Judge Rodriguez said he “respectfully disagrees with the majority and agrees with the dissent. The plain language of Rule 3002.1(i) places few restrictions on the types of remedies bankruptcy courts can issue.” The rule’s only limit, he said, is the word “appropriate” while the word “including” is not limiting.

For Judge Rodriguez, going beyond compensatory damages “best serves the policy goals underlying the bankruptcy system.” Costs and attorneys’ fees alone “may be insufficient,” he said, because violations “may either go unnoticed by the debtor or the debtor will find it easier to pay the small fees rather than litigate them.”

Judge Rodriguez therefore denied the lender’s motion to dismiss by holding that “sanctions and punitive damages may be assessed under Rule 3002.1(i)(2) as ‘other appropriate relief’ where circumstances warrant. Plaintiffs must nevertheless satisfy their evidentiary trial burden to prove they are entitled to such relief.”

The opinion by Judge Rodriguez has several other holdings on issues that arise from time to time in consumer bankruptcies. He analyzed whether claim preclusion or judicial estoppel would bar the debtor from attempting to avoid the mortgage in the second case when there had been no claim to that effect in the first case.

Judge Rodriguez also denied the lender’s motion to dismiss the debtors’ claims about violating the automatic stay and the discharge injunction.

Observations

Don’t hold your breath waiting for a ruling on appeal. The decision by Judge Rodriguez is interlocutory, and the case doesn’t seem an attractive candidate for an interlocutory appeal.

There may be a settlement, precluding us all from knowing whether the Fifth Circuit would disagree with the Second Circuit.

Without a settlement, the lender will face the expense of a trial before Judge Rodriguez, followed by appeals to the district court and the circuit.

Since appeals could go in favor of the debtor and make bad law for lenders and servicers, the financial community could be better off having *Gravel* as the only appellate authority regarding Rule 3002.1.

[The opinion is](about:blank) *Blanco v. Bayview Loan Servicing LLC (In re Blanco)*, 20-10078, 2021 BL 347772, 2021 Bankr Lexis 2502 (Bankr. S.D.N.Y. Sept. 14, 2021).

### Stays & Injunctions

#### Pennsylvania’s Judge Conway hints that failure to stop proceedings after bankruptcy can be an automatic stay violation, even after Fulton.

# Refusing to Release an Attachment After Filing Is No Stay Violation Following *Fulton*

After *Fulton*, a creditor’s refusal to lift the attachment of a bank account is no violation of the automatic stay under any subsection Section 362(a), according to Bankruptcy Judge Mark J. Conway of Wilkes-Barre, Pa.

The October 6 opinion by Judge Conway hints that a creditor must stop legal proceedings after bankruptcy that would impair the debtor’s interest in property, *Fulton* notwithstanding.

The Pre-Filing Attachment

Before bankruptcy, the creditor obtained a $33,300 judgment against the soon-to-be debtor. Also before bankruptcy, the creditor obtained a writ of execution and served it on a credit union holding an account belonging to the debtor that contained about $1,100.

Service of the writ froze the account and gave the creditor a judicial lien. After service of the writ, the debtor filed a chapter 13 petition. The creditor did not undertake further proceedings in state court after bankruptcy that would have been required to transfer the funds in the account from the credit union to the creditor.

On several occasions after filing, counsel for the debtor contacted the lender and demanded the lifting of the attachment. The lender declined.

A few months after filing, the debtor commenced an adversary proceeding against the lender, alleging a willful violation of the automatic stay under Section 362(k), thereby opening the door to actual and punitive damages and attorneys’ fees. The complaint also sought turnover.

The debtor and the creditor filed cross-motions for summary judgment. Before the hearing, the debtor confirmed a plan promising to pay the creditor in full, and the lender released the funds in the account to the debtor.

Judge Conway was therefore only required to rule about a stay violation and contempt.

Nothing Offended in Section 362(a)

Naturally, *Fulton* was front and center. *See* *City of Chicago v. Fulton*, 141 S. Ct. 585, 208 L. Ed. 2d 384 (Sup. Ct. Jan. 14, 2021). The Supreme Court held “that mere retention of property does not violate the [automatic stay in] § 362(a)(3).” *Id*. 141 S. Ct. at 589. Section 362(a)(3), the Court said, only “prohibits affirmative acts that would disturb the *status quo* of estate property.” *Id*. at 590.

In *Fulton*, the City of Chicago was itself holding the debtor’s car at the time of the chapter 11 filing. Admitting that the lender had taken no action after bankruptcy, the debtor contended that *Fulton* did not apply because the credit union was in possession of the funds, not the judgment creditor.

Judge Conway first analyzed the facts under Section 362(a)(3), the same subsection at issue in *Fulton*. That section prohibits “any action” to obtain possession or exercise control over estate property.

In the case at hand, Judge Conway said that the creditor’s actions were “perhaps more appropriately characterized as inactions.” He paraphrased *Fulton* as holding that “the mere retention of estate property” is no stay violation.

Applying *Fulton*, Judge Conway held that the creditor’s refusal to withdraw the prepetition attachment “does not violate Section 362(a)(3).” Rather, the creditor only maintained the *status quo*. Further, withdrawing the attachment could have deprived the creditor of its judicial lien on the account.

Judge Conway found no violation of the other subsections in Section 362(a).

Subsections (a)(4) through (a)(6) likewise bar “any action” to create or enforce a lien or to recover on a prepetition claim. Given that the creditor had a lien before the filing date, Judge Conway said that the creditor “had to have done something post-petition” to violate subsections (a)(4) or (a)(5). Likewise, he held that the “mere retention of a valid pre-petition” attachment does not violate (a)(4) through (a)(6).

Next, Judge Conway examined Section 362(a)(1). The debtor claimed there was an (a)(1) violation because the subsection does not begin with “any act.” Rather the subsection bars the “commencement or continuation” of a proceeding to collect on a claim.

Judge Conway approvingly cited *In re Iskric*, 496 B.R. 355 (Bankr. M.D. Pa. 2013), where the court found a stay violation because the creditor allowed the continuation of state court proceedings resulting in the debtor’s incarceration.

Judge Conway read *Iskric* as “an example of a factual scenario where if a creditor has put a process into effect that, without intervention, causes a change in the *status quo* as to property of the estate or the debtor, then a creditor must act to avoid that change.”

Cases like *Iskric* did not apply, in Judge Conway’s opinion, because the creditor “did nothing to further or ‘continue’ the garnishment process.”

Similarly, the creditor did not violate Section 362(a)(2), prohibiting enforcement of a judgment. Judge Conway held that the failure to withdraw the attachment “cannot be construed as, or equated with, taking an affirmative action to enforce a judgment.”

In short, Judge Conway granted summary judgment in favor of the creditor by dismissing the complaint.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Margavitch.pdf) *Margavitch v. Southlake Holdings LLC (In re Margavitch)*, 20-00014 (Bankr. M.D. Pa. Oct. 6, 2021).

### Wages & Dismissal

#### The Ninth Circuit leaves the door open for a bankruptcy court to sanction a misbehaving chapter 13 debtor before granting the debtor’s motion for voluntary dismissal.

# Another Circuit Holds that Dismissal Is Mandatory Under Section 1307(b)

Concluding that *Law v. Siegel*, 571 U.S. 415 (2014), implicitly overruled its own precedent, the Ninth Circuit held on September 1 that a bankruptcy court must dismiss a chapter 13 case on motion by the debtor under Section 1307(b), regardless of the debtor’s abusive conduct.

Significantly, the appeals court left the door open for the bankruptcy court to address the debtor’s misconduct alongside dismissal.

The Sixth Circuit reached the same result less than three months ago. *See* *Smith v. U.S. Bank N.A. (In re Smith)*, 20-3150, 2021 BL 318517 (6th Cir. June 9, 2021). There, the Cincinnati-based appeals court held that the bankruptcy court must dismiss a chapter 13 petition, even when the latest repeat filing was in bad faith. To read ABI’s report, [click here](about:blank).

Like the Ninth Circuit, the Sixth Circuit hinted that a debtor cannot dismiss to evade the consequences of misconduct.

The Facts

Husband and wife debtors filed a chapter 13 petition. Later, they were indicted in federal court for fraud.

According to the opinion by Circuit Judge Diarmuid F.O’Scannlain, the debtors refused to make disclosures in bankruptcy court for fear of compromising their defenses in the criminal action. They refused to hold a meeting of creditors, did not file tax returns, and did not propose a plan.

The creditor who was the victim of the alleged fraud filed a claim in the chapter 13 case, along with a motion for conversion to chapter 7 under Section 1307(c). The bankruptcy court decided that conversion would be proper under Section 1307(c) and (e), but the debtors asked for more time to cure their defaults.

The bankruptcy court gave them 30 days. The debtors did not comply but filed a motion for voluntary dismissal under Section 1307(b) before the 30 days ran out.

Relying on Ninth Circuit authority, *Rosson v. Fitzgerald (In re Rosson)*, 545 F.3d 764 (9th Cir. 2008), the bankruptcy court denied the motion to dismiss and converted to chapter 7. The debtor appealed, but the Ninth Circuit Bankruptcy Appellate Panel affirmed.

The outcome in the Ninth Circuit turned on *Law* and Section 1307(c), which provides that, “On request of the debtor at any time, . . . the court shall dismiss a case under this chapter.”

*Law* Overrules *Rosson*

In *Rosson*, the debtor had been directed to deposit proceeds from an arbitration award. When the debtor didn’t, the bankruptcy court intended to convert the case to chapter 7 *sua sponte*. Before the bankruptcy court could convert, the debtor filed a motion to dismiss under Section 1307(b). The bankruptcy court converted and denied the motion to dismiss.

Noting a circuit split but upholding conversion, the Ninth Circuit in *Rosson* read *Marrama* to mean that an unqualified right to dismiss was subject to the bankruptcy court’s powers under Section 105(a). *Id*. at 773.

Six years later, the Supreme Court handed down *Law*, reversing the Ninth Circuit. Judge O’Scannlain paraphrased *Law* as making clear “that a bankruptcy court may not use its equitable powers under § 105(a) to contravene express provisions of the Bankruptcy Code.”

Judge O’Scannlain had “no doubt that *Law* undercuts the reasoning of *Rosson*.” He therefore held that “*Rosson* has been effectively overruled by *Law* and is no longer binding precedent in this Circuit.”

Freed from circuit precedent, Judge O’Scannlain held:

Section 1307(b)’s text plainly requires the bankruptcy court to dismiss the case upon the debtor’s request. There is no textual indication that the bankruptcy court has any discretion whatsoever.

Judge O’Scannlain acknowledged that the Fifth and Eighth Circuits had held to the contrary, but both decisions came down before *Law*. Those decisions, he said, both rely on a “now-discredited theory.” He noted that no circuit has aligned itself with those two circuits after *Law*.

Judge O’Scannlain said that the “absolute right” to dismiss is “entirely consistent” with the policy of Section 303(a), designed to make chapter 13 a voluntary alternative to chapter 7. He thus held that the “debtor [has] an absolute right to dismiss a Chapter 13 bankruptcy case, subject to the single exception” in Section 1307(b) for debtors whose cases previously had been converted from chapters 7, 11 or 12.

Immediately before reversing and remanding, Judge O’Scannlain said:

We are confident that the Bankruptcy Code provides ample alternative tools for bankruptcy courts to address debtor misconduct.

Observations

Can a chapter 13 debtor play fast and loose with the court and creditors, then lay down a get-out-of-jail-free card if it doesn’t go well? Does the Ninth Circuit mean that a bankruptcy court must dismiss *immediately* when the debtor files a voluntary dismissal motion under Section 1307(b)?

In line with Judge O’Scannlain’s reference to “ample alternative tools,” perhaps a court could defer dismissal long enough for a creditor to obtain relief from the automatic stay.

Perhaps also, the bankruptcy court could defer dismissal for long enough to impose sanctions under Rule 11.

And most significantly, perhaps the bankruptcy court could dismiss, but dismiss with prejudice, and thereby render claims nondischargeable.

It is difficult to believe that Congress wrote a statute to mean that debtors can evade the consequences of their own misconduct.

[The opinion is](about:blank) *Nichols v. Marana Stockyard & Livestock Market Inc. (In re Nichols)*, 20-60043, 2021 BL 330861 (9th Cir. Sept. 1, 2021).

#### Ninth Circuit BAP doesn’t require a formal motion to dismiss with prejudice when a debtor files a voluntary motion to dismiss as of right under Section 1307(b).

# A Motion to Dismiss as of Right Doesn’t Bar the Court from Dismissing with Prejudice

A chapter 13 debtor filed a motion under Section 1307(b) for dismissal of right. Had he succeeded, the debtor would have been entitled to file again and attempt to discharge all his debts, because Section 349(a) says that dismissal does not bar discharging debts in a later case, unless the court orders otherwise for cause.

However, a creditor opposed the debtor’s motion for dismissal without prejudice and asked for the dismissal to be made with prejudice. Significantly, the creditor never filed a cross motion seeking dismissal with prejudice under Section 1307(c).

Finding “egregious” conduct by the debtor, the Bankruptcy Judge Martin R. Barash of Woodland Hills, Calif., dismissed the chapter 13 case with prejudice. Dismissal with prejudice had the same effect as a denial of discharge of the debtor’s then-existing debts.

Was there an error in dismissing with prejudice in the absence of a formal motion to that effect?

Writing for the Ninth Circuit Bankruptcy Appellate Panel on July 27, Bankruptcy Judge Christopher M. Klein found no error and upheld dismissal with prejudice.

Judge Klein’s erudite opinion reads like a treatise, laying out everything there is to know about the proper procedures, standards, burdens of proof and burdens of persuasion when it comes to dismissal with or without prejudice.

The Misbehaving Debtor

The debtor had filed chapter 12 petitions in 2010 and 2012. The 2012 case converted to chapter 7 followed by the entry of discharge.

The debtor filed a chapter 13 petition in 2018. A creditor, whom Judge Klein called the debtor’s nemesis, opposed confirmation of the debtor’s plan. In the objection, the creditor said that the case should be either dismissed or converted. The creditor did not file a motion to dismiss or convert.

The bankruptcy court heard witnesses and took evidence at a two-day confirmation trial. The issues included the debtor’s good faith, or lack of it.

In post-trial briefing, the creditor urged the court to dismiss with prejudice for bad faith. Again, the creditor did not file a motion to convert or dismiss with prejudice under Section 1307(c).

Conceding that his plan could not be confirmed, the debtor filed a motion to dismiss under Section 1307(b). The creditor filed an opposition to the motion to dismiss and asked for dismissal with prejudice under Section 349(a) for egregious bad faith. Again, the creditor did not file a motion to dismiss under Section 1307(c).

Section 1307(c) allows the U.S. Trustee or a party in interest to move for conversion or dismissal by showing “cause.”

The bankruptcy court held another hearing and considered the entire record. Technically speaking, the only motion before the court was the debtor’s motion to dismiss under Section 1307(b) and the creditor’s opposition with a request for dismissal with prejudice under Section 349(a).

In his decision, Bankruptcy Judge Barash cited the four-part test in *Leavitt v. Soto (In re Leavitt)*, 171 F.3d 1219 (9th Cir. 1999), *aff’g* 209 B.R. 935 (9th Cir. BAP 1997), as governing authority to determine whether the totality of the circumstances warranted dismissal with prejudice. Judge Barash dismissed with prejudice, after finding egregious and inequitable bad faith plus manipulation and abuse of the Bankruptcy Code.

The debtor appealed, to no avail.

Procedures for Dismissal with Prejudice Under Section 349(a)

For the BAP, Judge Klein surveyed the subtle differences about dismissal under Sections 1307(b), 1307(c) and 349. “The salient point,” he said, “is that Section 349(a) is an independent question that applies to all forms of dismissal, including Section 1307(b).”

For example, Judge Klein explained how Section 349(a) and 1307(c) require “cause,” while a debtor’s motion under Section 1307(b) does not. “Unless the court, for cause, orders otherwise,” Section 1307(b) says that “the dismissal of a case under this title does not bar the discharge, in a later case under this title, of debts that were dischargeable in the case dismissed. . . .”

There are different forms of dismissal with prejudice. The weak form, Judge Klein said, can contain a temporary refiling prohibition or provide that a new filing will not apply the automatic stay to a particular creditor. The strong form, he said, “is tantamount to denial of discharge” and is reserved “for egregious circumstances and necessitates that courts proceed with caution and pay attention to due process requirements consistent with denial of discharge.”

The bankruptcy court properly applied *Leavitt*, Judge Klein said. Although *Leavitt* dealt with “cause” for dismissal under Section 1307(a), he saw “no principled reason” why it should not also apply to Section 1307(b) dismissals.

Procedurally speaking, Judge Klein ran into a problem. Although *Leavitt* may be the standard, the rules and the Code don’t say when or how the Section 349(a) prejudice issue must be raised.

In the case on appeal, the procedures afforded due process consistent with complaints to deny discharge under Section 727. In addition, the creditor’s opposition to the debtor’s motion to dismiss without prejudice “was a correct procedure for presenting the Section 349(a) issue to the court.”

Next, Judge Klein said that the bankruptcy court correctly treated the dispute as a Rule 9014 contested matter. He therefore found no error in the procedure leading to dismissal with prejudice.

Next, Judge Klein dealt with the burden of persuasion. The creditor, he said, has the burden because dismissal with prejudice is “tantamount to denying discharge.”

With regard to how much evidence it takes to carry the burden of persuasion, Judge Klein said that the “quantum” required to overcome the presumption of discharge without prejudice “is likewise influenced by the emphasis on egregious circumstances and the similarity to the consequences of denial of discharge.”

Even if the quantum for a strong form of dismissal with prejudice were more than the preponderance of the evidence, Judge Klein said that the creditor had proven “a ‘huge’ and egregious manipulation of bankruptcy process in bad faith.” The evidence, he said, was “overwhelming.”

The evidence and the findings were more than sufficient to justify dismissal with prejudice.

Given the findings, did the bankruptcy court abuse its discretion in dismissing with prejudice?

The bankruptcy court had employed the proper *Leavitt* standard and made findings supported by the record that were neither illogical nor implausible. Judge Klein thus concluded there was no abuse of discretion in dismissing with prejudice.

In short, “the debtor’s ‘right’ to dismiss under §1307(b) does not immunize the debtor from the consequences of an adverse § 349(a) determination,” Judge Klein said.

Observations

There is a split of circuit on the question of whether a court must dismiss when a debtor files a motion to dismiss under Section 1307(b).

Splitting with the Fifth and Ninth Circuits, the Sixth Circuit held in June that the bankruptcy court must dismiss a chapter 13 petition, even when the latest repeat filing was in bad faith. *See* *Smith v. U.S. Bank N.A. (In re Smith)*, 999 F.3d 452 (6th Cir. June 9, 2021). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/sixth-circuit-creates-a-split-by-requiring-dismissal-of-an-abusive-chapter-13).

*Smith* and Judge Klein’s opinion are not necessarily incompatible. If importuned and if the evidence were sufficient, a court could respond to a debtor’s motion under Section 1307(b) by dismissing, except with prejudice.

If that’s true, a debtor’s motion to dismiss isn’t a get-out-of-jail-free card, nor should it be.

On Language — Old Word Resurrected

Near the end of the opinion, Judge Klein said that the debtor’s “Nemesis was not willing to let [the debtor] absquatulate.”

Quoting an academic, Judge Klein said that the word absquatulate was invented following the Panic of 1837:

The newly independent Republic of Texas gained a reputation as a popular destination for dishonorable failures. . . . “Gone to Texas,” abbreviated in “three ominous letters G.T.T.,” became a shorthand symbol found on abandoned businesses. . . . Absconding to squat on western lands and perambulate from one property to another had become so common a practice that writers invented a new verb to describe this process: to absquatulate.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Duran.pdf) *Duran v Gudino (In re Duran)*, 20-1045, 2021 BL 283667 (B.A.P. 9th Cir. July 27, 2021).

#### Debtor accepted a bar to refiling to avoid dismissal with prejudice of her chapter 13 case.

# Bad Faith Permits Dismissal of a Chapter 13 Case with Conditions, Judge Waites Says

In an area where the courts are split and the Fourth Circuit has no precedent, Bankruptcy Judge John E. Waites of Columbia, S.C., decided that the Bankruptcy Code allowed him to attach conditions when a debtor asks for dismissal of her chapter 13 case as of right under Section 1307(b).

The debtor refused to appear at her continued meeting of creditors. The chapter 13 trustee was hot on her trail, suspecting that she had not fully disclosed her assets and may have made voidable transfers.

The trustee filed a motion for conversion to chapter 7 under Section 1307(c). The debtor responded with a motion to dismiss as of right under Section 1307(b), which provides, “On request of the debtor at any time, . . . the court *shall dismiss* a case under this chapter.” [Emphasis added.]

The trustee and creditors objected to dismissal.

In his September 29 opinion, Judge Waites laid out the split. The Second, Sixth and Ninth Circuits, he said, give a chapter 13 debtor “an absolute and unqualified right to dismiss a Chapter 13 case that has not been previously converted.” In the Ninth Circuit, the case is *Nichols v. Marana Stockyard & Livestock Market Inc. (In re Nichols)*, 20-60043, 2021 BL 368629, 2021 Us App Lexis 29302 (9th Cir. Sept. 1, 2021). To read ABI’s report on *Nichols*, [click here](https://www.abi.org/newsroom/daily-wire/another-circuit-holds-that-dismissal-is-mandatory-under-section-1307b).

On the other side of the fence, Judge Waites cited opinions from the Fifth and Eighth Circuits holding that dismissal under Section 1307(b) may be conditioned on the debtor’s good faith.

The Fifth and Eighth Circuits rested their decisions in part on *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), where the Supreme Court held under Section 706(a) that the bankruptcy court has discretion to deny conversion of a chapter 7 case to chapter 13 as a consequence of the debtor’s bad faith.

But then came *Law v. Siegel*, 571 U.S. 415 (2014), where the Supreme Court held that a bankruptcy court may not use its equitable powers under Section 105(a) to contravene express provisions of the Bankruptcy Code. More particularly, the Court held that a bankruptcy court may not employ equitable powers to invade a debtor’s homestead exemption.

Judge Waites also mentioned that *Marrama* was a 5/4 decision. The dissenters in *Marrama* saw nothing in the text of Section 706(a) to deprive the debtor of the right to convert.

On motions by a debtor to dismiss under Section 1307(b), Judge Waites said that “[r]ecent and more convincing authorities” have taken *Law* to mean that a chapter 13 debtor may not “be precluded from voluntarily dismissing his or her Chapter 13 case in the face of a pending motion to convert or allegations of bad faith conduct.”

Nonetheless, Judge Waites said that his understanding of Section 1307(b) “does not preclude the view that other portions of the Bankruptcy Code, such as 11 U.S.C. § 349(a) or 11 U.S.C. § 109(g), provide the Court with authority to issue remedial orders in addition to an order granting a debtor’s motion to dismiss under § 1307(b) to address a debtor’s bad faith conduct or abuse of the bankruptcy process.”

Judge Waites was prepared to hold a hearing to decide whether he would dismiss with prejudice. Had he done so, the debtor’s debts outstanding on the filing date would have become nondischargeable if the debtor were to file again.

To fend off a disastrous ending to her chapter 13 case, the debtor negotiated a settlement where she agreed that the order of dismissal would bar another filing for two years. She also agreed that creditors could serve process by mail in state court proceedings.

Judge Waites entered an order dismissing and effecting the compromise.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Minogue.pdf) *In re Minogue*, 21-01779 (Bankr. D.S.C. Sept. 29, 2021).

#### Tenth Circuit splits with the Third and Seventh Circuits on allowing a debtor to cure defaults after a five-year plan has ended.

# Circuits Split on Allowing Debtors to Cure Chapter 13 Plan Defaults After Five Years

Splitting with the Third and Seventh Circuits, the Tenth Circuit held that a chapter 13 debtor cannot cure a post-confirmation default on a mortgage after the five-year plan has expired. In other words, the appeals court believes that a belated payment would be an impermissible modification of the plan after the term of the plan has ended.

Even though the debtor had tendered cure payments, the appeals court upheld dismissal of the case, with the effect of denying the debtor’s discharge, although she had made all plan payments to the chapter 13 trustee.

The Accident and the Default

In 2014, the debtor confirmed her chapter 13 plan, with monthly mortgage payments going directly to the lender. She was current on the mortgage at filing and remained current until she had an auto accident in 2018. With additional expenses after the accident, the debtor missed two mortgage payments “in the final months of her five-year plan,” Circuit Judge Robert E. Bacharach said in his July 23 opinion for himself and Circuit Judge David M. Ebel.

Parenthetically, Judge Bacharach said the debtor missed two more mortgage payments after the plan was over.

Following the conclusion of the plan, the bank filed a motion to dismiss. The debtor opposed the motion, tendered the defaulted payments and proposed that she be granted a discharge after paying the arrears.

Although not mentioned in Judge Bacharach’s opinion, the debtor evidently did not file a motion asking for a hardship discharge under Section 1328(b).

Bankruptcy Judge Elizabeth E. Brown of Denver granted the motion to dismiss and denied a motion for reconsideration. The Tenth Circuit granted a direct appeal, overstepping an intermediate appeal to the district court or the Bankruptcy Appellate Panel.

A Cure or a Plan Modification?

Judge Bacharach stated the question as follows: Were the tendered payments a permissible cure or an impermissible attempt to modify the plan after the term of the plan had ended?

More precisely, Judge Bacharach asked whether the proffered cure would be a payment made “under the plan,” therefore entitling the debtor to a discharge under Section 1328(a). That section provides that the court “shall” grant a discharge “after completion by the debtor of all payments under the plan.” Of course, the debtor contended that cure payments would be made “under the plan.”

The bank argued, successfully, that the proffered payments were not a cure but were an impermissible modification of the plan after the five-year term of the plan had ended.

What Does ‘Under the Plan’ Mean?

Judge Bacharach said that the courts differ on the meaning of “after completion by the debtor of all payments under the plan.” He cited a string of cases holding that untimely payments are allowable, while “many other courts” believe that late payments are not made “under the plan.”

While the lower courts are split on whether late payments are permissible, the Third and Seventh Circuits have found discretion to allow a final payment after five years. See In re Klaas, 858 F.3d 820 (3d Cir. 2017); and Germeraad v. Powers, 826 F.3d 962 (7th Cir. 2016). For ABI’s reports on those cases, [click here](https://www.abi.org/newsroom/daily-wire/third-circuit-permits-last-chapter-13-plan-payment-beyond-60-months) and [here](https://www.abi.org/newsroom/daily-wire/seventh-circuit-requires-chapter-13-payments-beyond-five-years).

Judge Bacharach said the disagreement was “understandable” given “the ambiguity inherent in the combination of §§ 1307(c), 1322, 1325, 1328(a), and 1329.”

To resolve the ambiguity, Judge Bacharach took counsel from *Fla. Dep’t of Revenue v. Piccadilly Cafeterias Inc.*, 554 U.S. 33 (2008), which he interpreted to mean that “the payments are ‘under the plan’ only if they are subject to or under the authority of the plan.”

In the case on appeal, “the more natural reading here is that the payments could fall ‘under’ a plan only if the plan remained in existence,” Judge Bacharach said. In other words, payments “would permit a discharge only if they had been made during the existence of the plan.”

Of course, the term of the plan had ended, making the debtor ineligible to modify the plan and receive a discharge.

As a backstop, Judge Bacharach looked at legislative history because he had found the statute to be ambiguous. He was persuaded by the House Report and the notion that amended chapter 13 was designed to have “strict deadlines” preventing plans from running longer than five years.

Judge Bacharach upheld dismissal because “the plan’s expiration left the bankruptcy court without authority to grant a discharge.”

The Concurrence

Circuit Judge Allison H. Eid concurred in the judgment. She found no ambiguity in the statute. In her view, “a plan can only last five years.”

A “plan expires after five years,” Judge Eid said, “and payments cannot be ‘under’ a plan that has come to an end.” She concurred only in the judgment and not in finding the statute to be ambiguous.

Observations

The Tenth Circuit’s strict reading creates problems, particularly if the default occurs shortly before the end of the term of the plan, leaving the debtor no time to cure. Or, what if the trustee has miscalculated required payments? Is the debtor barred from making up the shortfall after the plan ends?

In the case on appeal, the debtor would have been a good candidate for a hardship discharge. In that regard, the court’s ability to grant a hardship discharge under Section 1328(b) suggests there is flexibility in the statute. The section allows the court to grant a discharge “at any time after the confirmation of the plan” if the default “is due to circumstances for which the debtor should not justly be held accountable.”

Although not free from doubt, the words “at any time after confirmation” suggest that the end of the term of the plan is not a cutoff for filing a hardship discharge motion. If that’s true, then why can’t a court provide a better result for creditors by allowing the debtor to make all payments required by the plan?

Although not considered in the circuit’s opinion, barring a debtor from curing plan defaults seems grossly unfair for someone who has diligently made payments for five years, to the best of her or his ability. Indeed, if the debtor might be entitled to a hardship discharge, why not allow the debtor to cure defaults and ensure her right to a discharge?

[The opinion is](https://abi-opinions.s3.amazonaws.com/Kinney+v.+HSBC.pdf) *Kinney v. HSBC Bank USA N.A. (In re Kinney)*, 20-1122, 2021 BL 280759 (10th Cir. July 23, 2021).

#### Section 1326(a)(2) by itself does not bar garnishment of funds held by a trustee on dismissal before confirmation.

# On Dismissal of a ‘13,’ *Barton* May (or May Not) Bar Garnishments

If a chapter 13 case has been dismissed before confirmation, the Tenth Circuit Bankruptcy Appellate Panel seems inclined to allow judgment creditors to garnish funds that the trustee would otherwise return to the debtor.

The nonprecedential opinion on April 27 by Bankruptcy Judge Michael E. Romero includes an in-depth survey of the split on Section 1326(a)(2) and questions like the right of a chapter 13 trustee to collect a fee when dismissal occurs before confirmation. The opinion examines decisions going both ways on the right of creditors to garnish funds held by the trustee on dismissal of a chapter 13 case.

$29,000 Held by the Trustee on Dismissal

In the case before the BAP, the debtor had filed three successive chapter 13 petitions. The previous two had been dismissed quickly.

In the third and last case, the debtor filed to prevent state court clerks from collecting some $30,000 in judgments made in sanction for frivolous and vexatious litigation.

Eventually, the bankruptcy court refused to confirm the debtor’s chapter 13 plan. Together with denial of confirmation, the bankruptcy court dismissed the chapter 13 case. On dismissal, the chapter 13 trustee was holding about $29,000, after deducting the trustee’s fees.

The debtor’s former wife and the state court clerks filed motions for authority to garnish the funds being held by the trustee that would otherwise be distributed to the debtor under Section 1326(a)(2). The wife contended that her domestic support obligations were prior to the clerks’ judgments.

Section 1326(a)(2) and the *Barton* Doctrine

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing.

Subsection (a)(2) provides that payments made by the debtor “shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b).”

The bankruptcy court denied the motions, finding that the burden and inconvenience imposed by the garnishments on the trustee would not permit an exception to the *Barton* doctrine. The bankruptcy judge also decided that the plain language of Section 1326(a)(2) precluded diverting the funds away from the debtor in garnishment. The bankruptcy judge stayed his order pending appeal.

First pronounced by the Supreme Court in 1881 in *Barton v. Barbour*, 104 U.S. 126 (1881), the Supreme Court made a “general rule” that receivers could not be sued without permission from the appointing court. *Id.* at 128. The doctrine was expanded to cover bankruptcy trustees after adoption of the Bankruptcy Act of 1898. Later still, *Barton* was broadened to protect court-appointed officials and fiduciaries, such as trustees’ and debtors’ counsel, real estate brokers, accountants, and counsel for creditors’ committees.

As Judge Romero said in his opinion, *Barton* was further extended to cover trustees after dismissal.

*Barton* Applies to the Garnishments

The BAP agreed with the bankruptcy court that *Barton* applied, meaning that the creditors could not garnish funds held by the trustee without the bankruptcy court’s permission. As Judge Romero said, however, the holding “speaks only to whether pre-suit leave is required, not whether such leave should or should not be granted.”

Next, Judge Romero analyzed caselaw laying out factors to consider when deciding whether actions should be permitted despite *Barton*. For the BAP, he ruled that the “mere possibility of inconvenience cannot serve as a blanket protection for trustees from a legal process to which any other person may ordinarily be subjected.”

On *de novo* review, the BAP agreed that *Barton* required court approval before initiating garnishment. On the other hand, the panel ruled that the bankruptcy court had “abused its discretion by denying *Barton* leave based upon unsupported allegations of potential inconvenience to the Trustee without weighing the other important factors bearing upon such a decision.”

Section 1326(a)(2)

Regardless of *Barton*, the bankruptcy court had also decided that Section 1362(a)(2) barred the proposed garnishment.

As Judge Romero explained, there are two lines of cases interpreting Section 1362(a)(2). The courts taking a “plain meaning” approach conclude generally that a chapter 13 trustee must return everything to the debtor. For example, he cited an unpublished Alabama decision holding that the section preempts state law garnishments.

The other line of cases, Judge Romero said, take “a more practical approach” and view the section in a broader context. Those courts as a general matter would permit a trustee to deduct his or her fee before returning the remainder to the debtor, after payment of outstanding administrative claims.

More on point factually, Judge Romero discussed “debtor-of-a-debtor” cases that “approve of post-dismissal garnishments” by “taking a more nuanced and functional approach to applying the statute.”

In the debtor-of-a-debtor cases, Judge Romero said that the chapter 13 trustee “is effectively no longer operating as a court-appointed fiduciary” following dismissal and “can no longer be thought of as a representative of the estate exercising control over property of the estate.”

After dismissal, Judge Romero decided that “the legal relationship between the debtor and a trustee following dismissal is akin to a traditional bailment.” A bank, he said, “is not excused from complying” with a garnishment. He therefore saw “no reason why a different rule should apply to trustees merely because they were formerly an estate representative and the property used to be in *custodia legis* through an estate which no longer exists.”

In terms of the purpose of Section 1326(a)(2), Judge Romero saw the trustee as “in fact . . . returning the property to the debtor, not in the form of a cash payment, but in the form of a debt reduction . . . . The transfer may not be to the debtor, but it is nevertheless made for the debtor’s benefit.”

In short, the BAP ruled that Section 1326(a)(2) by itself did not preclude honoring the garnishments. The panel reversed and remanded for the bankruptcy court to conduct further proceedings on the *Barton* doctrine.

Observations

In the case before the BAP, the fee of the chapter 13 trustee was about $1,500.

In the case on appeal, the trustee was faced with competing garnishments. Who comes first? The court clerks or the former wife?

To ensure no liability in disbursing the funds, the trustee would become ensnared in further litigation in bankruptcy court or state court to decide who should be paid and how much. The $1,500 fee would quickly become a losing proposition if the trustee were involved in deciding whom to pay.

A bright-line rule calling for payment to the debtor would aid the trustee in preventing the case from becoming a loser.

Jurisdiction is also an issue. Surely, the bankruptcy court at least has “related to” jurisdiction to decide which garnishment comes first. Why should the bankruptcy court rather than state court make such decisions after dismissal?

If the trustee were to return the funds to the debtor, the creditors would be justly concerned that the debtor would squirrel the money away before they could locate and attach the debtor’s bank account. Is it the purpose of the bankruptcy court to assist in the collection of judgments when the distribution is not being made under the Bankruptcy Code?

Courts are always inclined to sort out disputes when the parties and the *res* are before the court. Sometimes, however, the desire to resolve disputes should take second place behind regard for the court’s limited jurisdiction and the purpose of the forum.

Congress intended to give debtors incentives for attempting chapter 13 arrangements. That’s why Section 1326 gives funds back to the debtor on dismissal before confirmation. If the bankruptcy court becomes a collection agent when chapter 13 fails, is the intent of Congress being fulfilled?

Disallowing garnishments would not mean, by analogy, that a chapter 13 trustee cannot be paid if dismissal precedes confirmation. Trustees rely on 28 U.S.C. § 586(e) as statutory authority for being paid after dismissal. Creditors have no similar statutory authority to demand payments from a chapter 13 trustee on dismissal.

The foregoing factors could be considered in deciding whether *Barton* precludes honoring a garnishment.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Bednar.pdf) *Warren v. Bednar (In re Bednar)*, 20-041 (B.A.P. 10th Cir. April 27, 2021).

### Plans & Confirmation

#### ourts are split on whether chapter 13 effectively prohibits debtors from making voluntary contributions to 401(k) plans.

# Congress Must Decide: May Chapter 13 Debtors Contribute to 401(k) Plans?

Congress needs to fix the mess it made in Section 541(b)(7) and say clearly whether chapter 13 debtors are entitled to make voluntary contributions to 401(k) retirement plans. As it now stands, there are four interpretations of the section, typically giving three different results.

So far, only the Sixth Circuit has tackled the issue. It will be years before there is enough appellate authority for the Supreme Court to resolve what assuredly will be a split.

As a matter of public policy, it is imperative that Congress decide whether debtors are required to suffer the effects of bankruptcy years later in retirement, if they happen to live in districts and circuits that do not permit 401(k) contributions during chapter 13.

The New and Newer Sixth Circuit Opinions

In a 2/1 decision, the Sixth Circuit held last year that a chapter 13 debtor who was consistently making contributions to a 401(k) for six months before bankruptcy may continue contributions in the same amount by deducting the contributions from “disposable income” in Section 1325(b)(2).

The majority in *Davis* rejected the holding by some courts that contributions are never included in disposable income, whether or not the debtor was making contributions before bankruptcy. The dissenter would have held that a debtor cannot make contributions after bankruptcy, even if he or she was making them beforehand. *Davis v. Helbling (In re Davis)*, 960 F.3d 346 (6th Cir. 2020). To read ABI’s report on *Davis*, [click here](about:blank).

In a unanimous opinion on August 10, the Sixth Circuit held that a chapter 13 debtor may not make 401(k) contributions if the debtor had not been making contributions before bankruptcy, even if (1) the debtor had a history of making contributions in prior years when he was able, and (2) the debtor was not eligible for a 401(k) plan in the months before bankruptcy.

The new opinion was authored by Circuit Judge Joan Larsen. She was also the writer of the majority opinion last year in *Davis*.

The Four-Way Split

Section 541(b)(7)(A) is one of the most poorly drafted provisions in the Bankruptcy Code. It was added in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act because courts were mostly holding that wages voluntarily withheld as 401(k) contributions were part of disposable income.

As amended, the section provides that property of the estate does not include contributions to 401(k) plans. The end of the subsection includes a so-called hanging paragraph that says, “except that such amount under this subparagraph shall not constitute disposable income as defined in section 1325(b)(2).”

There are four interpretations of the statute, with three results: (1) Retirement contributions can never be deducted from disposable income, even if the debtor was making contributions before bankruptcy; (2) a debtor may continue making contributions, but not more than the debtor was making before bankruptcy; and (3) a debtor may make contributions after bankruptcy up to the maximum allowed by the IRS, even if the debtor was making none before bankruptcy.

This writer respectfully submits that none of the interpretations inexorably flows from the statutory language.

Facts in the New Case

For most of his 17 years working for a former employer, the debtor had been making contributions to his 401(k) plan. In 2017, he took a new job with an employer that did not offer a 401(k) plan, so he could not make contributions.

Six weeks before filing a chapter 13 petition in June 2018, the debtor went to work for a different employer offering a 401(k) plan and began making contributions. Judge Larsen said the record was unclear about when the debtor began making the contributions.

Before *Davis* came down, the bankruptcy court ruled that the debtor could not deduct the contributions from his payments to creditors. Also before *Davis*, the district court affirmed. To read ABI’s report on the district court opinion, [click here](about:blank). The appeal to the circuit was held in abeyance pending the outcome in *Davis*.

The new case presented facts not present in *Davis*. Although he had a history of making contributions, the debtor had made none consistently in the six months before bankruptcy.

Contributions Before Bankruptcy Are Required

The debtor argued that the circuit court should expand *Davis* by allowing the debtor to rely on his history of making voluntary contributions when he had been able to so do.

“Because neither the statute nor our caselaw supports” the argument, Judge Larsen upheld the lower courts.

Judge Larsen laid out the four interpretations of the statute and explained how *Davis* rejected the idea that a chapter 13 debtor may never make voluntary contributions. She cited the Sixth Circuit Bankruptcy Appellate Panel for having ruled that “to the extent a debtor is making recurring 401(k) contributions ‘at the time’ of filing, she may continue to do so post-petition.” *Burden v. Seafort* (*In re Seafort*), 437 B.R. 204, 209-210 (B.A.P. 6th Cir. 2010).

“But that also means that a debtor may not begin, resume, or otherwise increase the amount of such contributions post-filing in an attempt to reduce payments to unsecured creditors,” Judge Larsen said, again interpreting the BAP. *Id*. at 210.

Judge Larsen stated the circuit’s holding as follows:

We hold only that the bankruptcy code’s text does not permit a Chapter 13 debtor to use a history of retirement contributions from years earlier as a basis for shielding voluntary post-petition contributions from unsecured creditors. This is true even if the debtor had no ability to make further contributions in the six months preceding filing; the code makes no exception for such circumstances.

Commentary

In years past, employers offered defined-benefit pension plans that were protected in employees’ bankruptcies. Today, they are few and far between.

If a typical consumer is to provide for retirement, she or he must make contributions to 401(k)s and individual retirement accounts. Otherwise, a worker will be left with nothing more than Social Security benefits and retirement in abject poverty.

A financially struggling consumer may be unable to make 401(k) contributions, even if offered by the employer. Consequently, requiring consistent 401(k) contributions by chapter 13 debtors before bankruptcy flies in the face of reality. Furthermore, a consumer eligible for chapter 7 is not precluded from making contributions immediately after filing.

Typically, requiring a chapter 13 debtor to include 401(k) contributions in disposable income will not result in an additional major recovery by each unsecured creditor.

Congress needs to decide whether chapter 13 debtors must suffer the consequences of bankruptcy in retirement years later, when the benefit to each creditor was nominal.

Chapter 13 was designed not to be punitive when someone files a chapter 13 petition but does not succeed. Barring individuals from providing for retirement makes chapter 13 punitive for debtors who succeed.

[The opinion is](about:blank) *Penfound v. Ruskin (In re Penfound)*, 19-2200, 2021 BL 300792 (6th Cir. Aug. 10, 2021).

Judge Grossman didn’t abolish ‘chapter 20’ entirely. He required the debtor to treat the subordinate mortgage lender like all other unsecured creditors, even though the debtor’s personal liability to the lender had been discharged in the prior chapter 7 case.

# In ‘Chapter 20,’ Discharged Mortgage Claim Resurrects as Unsecured, EDNY Judge Says

He didn’t abolish so-called chapter 20 entirely, but Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., has made it unworkable for many chapter 13 debtors.

The typical chapter 20 case works like this: The consumer first files under chapter 7 to extinguish personal liability on a subordinate, underwater home mortgage. Later, sometimes the day after receiving a chapter 7 discharge, the consumer files a separate chapter 13 case to strip off the mortgage lien that survived chapter 7 as an in rem liability solely against the real property.

When chapter 20 works, the debtor emerges from the subsequent chapter 13 case with the underwater mortgage stripped off and no personal liability on the subordinate mortgage debt.

The Ninth Circuit Bankruptcy Appellate Panel has validated chapter 20, at least when the debtor receives a discharge in chapter 13. *See Washington v. Real Time Resolution Inc. (In re Washington)*, 602 B.R. 710 (B.A.P. 9th Cir. July 30, 2019). To read ABI’s report on *Washington*, [click here](about:blank).

In Judge Grossman’s modified version of chapter 20, the lien is stripped off in the subsequent chapter 13 case. Although the debtor’s personal liability on the mortgage note was discharged in the prior chapter 7 case, he ruled that the mortgage debt is nonetheless an unsecured claim to be treated like all other unsecured claims in the chapter 13 plan.

The Underwater, Subordinate Mortgage

The facts demonstrate why Judge Grossman’s modified chapter 20 was likely unpalatable for the debtor in the case before him.

The debtor had received a chapter 7 discharge 12 years earlier. She filed a chapter 13 petition in early 2021, listing her home with a value of about $550,000. The home was subject to an $850,000 first mortgage and a $300,000 second mortgage. The second, or subordinate, mortgage was underwater, meaning there was no equity in the property above the first mortgage to satisfy any portion of the second mortgage.

The debtor’s personal liability on the subordinate mortgage had been discharged in the prior chapter 7 case. However, the second mortgage remained a lien on her home as a consequence of *Dewsnup v. Timm*, 502 U.S. 410 (1992).

The debtor filed a chapter 13 plan promising to pay unsecured creditors 100%.

Aiming to escape all liability on the second mortgage and effectively void the second mortgage lien, the debtor filed a motion asking Judge Grossman to strip off the subordinate lien and declare that the lender’s unsecured claim would be zero under the chapter 13 plan.

In his August 5 opinion, Judge Grossman said he would strip off the lien, but he ruled that the entire amount of the mortgage debt would be a valid, unsecured claim in the debtor’s chapter 13 plan to be paid in full over the life of the plan, if the debtor were to confirm the plan.

The decision may have made chapter 13 unworkable for the debtor, given that she was proposing a 100% plan for unsecured creditors. Chapter 13 still might work if the best interests test would allow the debtor to reduce the percentage payout to an amount she could realistically afford.

Critique of Courts Permitting Chapter 20

Judge Grossman said that courts disagree on a chapter 13 debtor’s ability to strip off an underwater mortgage when the *in personam* obligation on the mortgage loan was discharged in a prior chapter 7 case.

Courts that eliminate subordinate mortgage debt in a subsequent chapter 13 rely on “several problematic assumptions,” Judge Grossman said. Those courts “equate[] the discharge injunction with the elimination of the underlying debt.” The discharge does not eliminate the debt, it only bars collection as a personal liability of the debtor, Judge Grossman said.

Judge Grossman went on to say that the claim filed by the mortgage holder in the chapter 13 case “is not an act to collect a discharged debt and does not run afoul of § 524.”

Courts that eliminate the debt in chapter 13 also overlook Section 522(c), Judge Grossman said. That section provides “that the property remains liable during and after the case for debt secured by a lien that is (i) not avoided under subsections (f) or (g), and (ii) not void under § 506(d).” Therefore, he said that “the *in rem* lien securing the mortgage claim that survives bankruptcy is protected to the extent that it is not void under § 506(d).”

Judge Grossman went on to say that Section 506(d) does not provide a mechanism to disallow a claim. As such, he said that the claim on the subordinate mortgage “is fully enforceable and cannot be disallowed under § 502.”

Judge Grossman held that the debtor “is required to treat [the subordinate lender] the same as all unsecured creditors. [The lender] and the Debtor’s other unsecured creditors are entitled to payment consistent with § 1325(a)(4) (the best interest of creditors test) and § 1325(b) (the disposable income test), which could mean payment of a small percentage of their claims or payment in full.”

Judge Grossman granted the debtor’s motion by allowing the debtor to strip off the lien but disallowed the motion to the extent that the debtor sought to reduce the amount of the claim to zero, based on an assumption that the debtor confirms a plan and receives a discharge.

Observations

There are good arguments on both sides of chapter 20. The aversion to eliminating both the claim and lien rests in part on the idea that the lender’s efforts at collecting the claim in the chapter 13 case is not in violation of the discharge injunction. Is the filing of a claim in chapter 13 an act to collect a discharged debt as a personal obligation of the debtor?

Section 102(2) cuts both ways. The section says a “claim against the debtor” includes a claim against property of the debtor. On the one hand, the section suggests that the lender’s *in rem* claim against the property is a claim against the debtor in chapter 13. On the other hand, does the section also suggest that the lender is violating the discharge injunction by asserting an *in rem* claim?

One day, the issue will reach several courts of appeals. There may be a split dropped into the laps of the justices on the Supreme Court, who may once again be asked to reexamine whether *Dewsnip* was correctly decided.

If the justices are inclined to believe that *Dewsnup* was a mistake that ignored the plain meaning of the statute (as the late Justice Antonin Scalia argued), debtors may prevail by stripping off the underwater lien while eliminating the mortgage debt in a later chapter 13 case.

Advocates of chapter 20 may have an attractive argument based on the plain language of the statutes, but those in Judge Grossman’s camp appeal to a sense of fairness in believing that a subordinate lender should have a claim paid the same percentage as other unsecured creditors.

[The opinion is](about:blank) *In re Hopper*, 21-70139 (Bankr. E.D.N.Y. Aug. 5, 2021).

#### No more informal ‘no-look’ fees in the courtroom of Bankruptcy Judge Robert Grossman.

# Long Island Judge Ends ‘Loss Mitigation’ in His Courtroom

Having decided that “Chapter 13 has morphed into the pursuit of loss mitigation as its sole purpose in which debtors file cases they never intend to bring to confirmation,” Bankruptcy Judge Robert E. Grossman decided it’s time to end so-called loss mitigation in his court.

In his February 28 opinion, Judge Grossman also decided it’s time to adopt a so-called no-look fee of $5,500 for chapter 13 cases in his court. Judge Grossman sits in Central Islip, N.Y.

Although Judge Grossman ended loss mitigation in his court, the case before him resulted in a confirmed chapter 13 plan after the debtor and the home mortgage lender agreed on a loan modification. Aside from the case before him, Judge Grossman said he would no longer approve attorneys’ fees for participation in loss mitigation, “absent extraordinary circumstances.”

The Protracted Loss Mitigation

We will assume everyone knows what “loss mitigation” means. For those who don’t, it’s typically a local rule where bankruptcy judges on request enter orders compelling the debtor and the mortgage lender to negotiate with the aim of agreeing on loan modification. Some courts have entered contempt citations against lenders who did not negotiate in good faith.

Until now, at least, most bankruptcy judges have had favorable views about loss mitigation. They would typically say that loss mitigation has allowed debtors to keep homes they otherwise would have lost absent court-mandated negotiations.

In the case before Judge Grossman, the debtor filed a chapter 13 petition and obtained an order directing loss mitigation. The process took two years but resulted in a confirmed plan and an agreed loan modification approved by the court.

The delay in reaching accord on loan modification, according to Judge Grossman, was occasioned mostly by the lender’s mistakes and ineptitude. The debtor and the debtor’s bankruptcy counsel carried out their part of the negotiations and documentation with dispatch.

The delay came at a cost. Before bankruptcy, the debtor had paid counsel a retainer of $3,000. In the engagement agreement, the debtor consented to an additional $2,500 counsel fee to be paid under the chapter 13 plan.

The client also agreed that the $5,500 would only cover specified services. Notably, the $5,500 fee did not cover participation in loss mitigation.

After confirmation, the debtor’s counsel filed a fee application for payment of about $9,200 on top of the $3,000 retainer. In other words, counsel’s fees for the chapter 13 case totaled some $12,200.

The Eastern District of New York has no local rule establishing a so-called no-look fee for chapter 13 cases. Without filing a fee application, courts with no-look fees will allow payment so long as it doesn’t exceed the prescribed amount. For greater compensation, counsel must file a traditional fee application.

In the absence of a formal no-look fee, some chapter 13 trustees in the New York Eastern District developed a practice where they would review counsel’s time records and advocate approval of the plan (and payment of the fee) if the trustee had no objection to the requested fee.

And so it was in the case before Judge Grossman. The chapter 13 trustee had no objection to confirmation of the plan and payment of the additional $9,200 fee to be paid by the trustee under the plan.

No More Informal No-Look Fees

In substance, the chapter 13 trustee in the case before Judge Grossman had implemented an informal no-look fee where compensation would be approved by the court if the trustee had no objection. No more, Judge Grossman said.

The informal fee approval process, Judge Grossman said, “was never the intent of the statute and is a process that will cease . . . . [T]he awarding of fees is the sole responsibility of the Court.”

Judge Grossman said he would be drafting “new rules” for his court “which give counsel to Chapter 13 debtors the option of either proceeding under what we designate a ‘presumptively reasonable [$5,500] fee’ which will allow the Court to award fees without the need for a hearing or filing a fee application.”

Judge Grossman said he would not require a fee hearing for fees of less than $5,500.

No More Loss Mitigation

“The Court will no longer entertain motions for loss mitigation in Chapter 7 or 13 cases,” Judge Grossman said.

During the housing crisis, Judge Grossman said that loss mitigation allowed “many families” to keep their homes, because otherwise it would have been “difficult for debtors to identify the party that held the mortgage.”

“While the aim of the loss mitigation program is noble, the circumstances that led to its implementation are now absent,” Judge Grossman said.

Now that the “onslaught of foreclosures and bankruptcy filings . . . has abated,” Judge Grossman said,

[L]oss mitigation has morphed into an institutionalized process not supported by the Bankruptcy Code. It now seemingly exists not for the purpose originally intended but rather for the benefit of professionals, trustees, and institutions, often to the economic detriment of the creditors. This is the antithesis of what Chapter 13 was designed to do.

“There is nothing in the Code,” Judge Grossman said, “which permits a bankruptcy court to forcibly restructure a residential mortgage.” Disagreeing with some other courts, he saw no power in Section 105(a) for mandatory loss mitigation.

Judge Grossman said he would still “encourage Chapter 13 debtors and their secured creditors to reach a consensual arrangement.” The judge said he would still order mediation, “but only on consent of the parties.”

The Remedy

Judge Grossman examined the attorney’s fee request, found it reasonable, and allowed payment “in the full amount requested.” He said it would be “the last application for compensation this Court approves which seeks additional fees for loss mitigation absent extraordinary circumstances.”

Judge Grossman said his “decision does not modify, amend, or limit loss mitigation procedures for any other judge in this Court or the Court generally.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Tcherneva.pdf) *In re Tcherneva*, 19-71413 (Bankr. E.D.N.Y. Feb. 28, 2022).

### Compensation

#### Finally, a circuit court cites Taggart to help a debtor enforce the discharge injunction.

# Second Circuit Allows Appellate Attorneys’ Fees for Upholding a Contempt Citation

Reversing the lower courts, the Second Circuit held that a debtor is entitled to recover attorneys’ fees for successfully prosecuting appeals from the bankruptcy court’s order holding a creditor in contempt of the discharge injunction.

The May 17 opinion by Circuit Judge Richard J. Sullivan may discourage creditors from appealing contempt citations, because a debtor’s appellate attorneys’ fees could exceed the damages assessed for violation of the discharge injunction or the automatic stay. In other words, attempting to set aside a hurtful precedent could entail costs greater than the creditor’s own attorneys’ fees.

The ‘Egregious’ Discharge Violation

The debtor obtained a discharge in chapter 7. Later, the mortgage lender made erroneous reports to credit agencies and more than 30 phone calls attempting to collect delinquent mortgage payments that had been discharged.

The bankruptcy judge ruled that the lender’s actions were “absolutely egregious.” She found the lender in contempt of the discharge injunction and assessed some $9,000 for the debtor’s legal fees and $17,500 for attempting to collect the discharged debt.

On the first appeal, the district court upheld the $9,000 award for violation of the discharge injunction but remanded for the bankruptcy judge to say whether the $17,500 was for actual or punitive damages.

On remand, the bankruptcy court reinstated the $17,500 award as compensatory damages. On remand, the debtor had sought another $28,000 for the attorney’s fees for the first appeal. The bankruptcy judge denied the appellate attorneys’ fees, believing that the appeal did not violate the discharge injunction and saying that the debtor should have requested appellate attorneys’ fees in district court.

The district court affirmed on a second appeal, saying that the bankruptcy court lacked the power to award attorneys’ fees for an appeal in district court.

The debtor’s counsel appealed to the circuit and won on both grounds.

‘Old Soil’ Helps Debtors this Time

Reviewing the bankruptcy court’s decision for abuse of discretion, Judge Sullivan found the contempt power in the Section 524 discharge provisions and in Section 105, which empowers the court to enter “any order . . . necessary . . . to carry out the provisions of” the Bankruptcy Code.

Quoting *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1801 (2019), Judge Sullivan said that those “‘provisions authorize a court to impose civil contempt sanctions’” and “‘bring with them the old soil that has long governed how courts enforce injunctions.’” He went on to say it was “well settled” that “a bankruptcy court may compensate a debtor for a creditor’s violation of its discharge order.”

For guidance from Second Circuit precedent, Judge Sullivan cited *Weitzman v. Stein*, 98 F.3d 717 (2d Cir. 1996), where the appeals court ruled that a lower court must give persuasive grounds for denying appellate legal costs arising from a contemnor’s misconduct. The *Weitzman* court noted that none of the litigation would have been necessary had the contemnor obeyed the district court’s order.

Judge Sullivan said that *Weitzman* “foreclosed” the lender’s argument that the appeal had not violated the discharge injunction, because the appeal would not have been necessary had the lender respected the discharge. “Put simply,” he said, the debtor’s appellate fees were caused by the lender’s contempt.

On policy grounds, Judge Sullivan noted that the $28,000 in fees for defending the first appeal were higher than the $17,500 damage award. He said that “the failure to compensate the victim of contempt with appellate fees could leave the victim worse off for seeking to enforce a discharge order and would, at the very least, discount any compensatory damages award.”

The lender’s argument that only the district court could award appellate attorneys’ fees was “equally unpersuasive,” Judge Sullivan said.

Bankruptcy courts have power to sanction for violation of the discharge injunction, and, Judge Sullivan said, “it is immaterial that this case involves a bankruptcy court’s, rather than a district court’s, contempt order.”

Again, Judge Sullivan said that the “old soil” permits a court to enforce its injunction to compensate for someone’s losses arising from noncompliance with an injunction.

The lender made other arguments that were unpersuasive. The bankruptcy and appellate rules allowing sanctions for frivolous appeal, Judge Sullivan said, do not “preclude[] a bankruptcy court from exercising the ‘old-soil’ power to award fees for non-frivolous appeals of its contempt order in appropriate circumstances.”

Judge Sullivan reversed and remanded with directions for the district court to remand the matter for the bankruptcy court to calculate the appropriate amount of appellate attorneys’ fees, or to articulate “persuasive grounds” for denying fees.

At the end of his opinion, Judge Sullivan added a zinger. He directed the bankruptcy court to decide on granting fees for the second appeal.

Tension with *Gravel*?

Last year, the Second Circuit held in *PHH Mortgage Corp. v. Sensenich (In re Gravel)*, 6 F.4th 503 (2d Cir. Aug. 2, 2021), that bankruptcy courts may not impose contempt sanctions for violating Bankruptcy Rule 3002.1. Rather, the majority ruled over a vigorous dissent that a debtor may only recover compensatory damages, which often will be nominal. To read ABI’s report on *Gravel*, [click here](about:blank).

To this writer, there is tension between the new case, finding common law grounds for imposing appellate attorneys’ fees, and the insistence in *Gravel* that contempt sanctions are not permitted under a rule without authorization in the statute or the rule.

True, the two cases can be distinguished on their facts. Perhaps the differing results can be explained, because the two cases had different panels of judges.

Until the Second Circuit smooths out the rough edges, debtors will cite the new case while creditors will rely on *Gravel*.

[The opinion is](https://abi-opinions.s3.amazonaws.com/DiBattista.pdf) *Law Offices of Francis J. O’Reilly v. Selene Finance LP (In re DiBattista)*, 20-4067 (2d Cir. May 17, 2022).

#### Local rules require lawyers to prepare and fill all required chapter 7 papers regardless of whether the debtor pays the fee or agrees to pay the fee.

# Bankruptcy Courts in Colorado and Minnesota Bar Bifurcated Fee Arrangements

Nine days apart, bankruptcy judges in Colorado and Minnesota disallowed so-called bifurcated fee arrangements where chapter 7 debtors paid nothing before filing. The two judges found multiple misrepresentations in the pre- and post-filing fee agreements, rendering them void and unenforceable under Section 526(c)(1).

It is doubtful whether any artfully drafted fee agreements could pass muster in Colorado and Minnesota, because the lawyer who files the petition is obliged to complete the representation whether or not the debtor pays or agrees to pay the fee after filing.

The impetus for bifurcated fee arrangements arose because the Supreme Court in *Lamie v. U.S. Trustee*, 540 U.S. 526, 538 (2004), ruled that an agreement signed before bankruptcy cannot compel a chapter 7 debtor to pay for services rendered before or after filing. In essence, *Lamie* compels chapter 7 debtors to pay the lawyer’s fee in full before filing.

As Bankruptcy Judge Thomas B. McNamara of Denver said in his May 10 opinion, “there may well be sound policy reasons for changing the Bankruptcy Code to allow attorneys to be paid postpetition for performing even pre-petition services. But, that is not the Court’s role . . . . Because the Pre-Filing Agreement and Post-Filing Agreement contain misrepresentations and are misleading, they are void.”

Scholarly Commentary

Prof. Nancy Rapoport told ABI, “It’s past time for Congress to fix this problem.”

Elaborating, Prof. Rapoport said:

There wouldn’t be such machinations, with some jurisdictions allowing bifurcations and some not, if Congress would act.

On the other hand, sometimes when Congress messes with the bankruptcy laws, the law gets worse, not better.

Also, there’s a lot to be said for making contracts that non-law-trained people understand that actually give them the correct options.

An expert on ethics in bankruptcy cases, Prof. Rapoport is the Garman Turner Gordon Professor of Law at the Univ. of Nevada at Las Vegas William S. Boyd School of Law.

The Pre- and Post-Filing Agreements

The pre- and post-filing retention agreements in both cases were lengthy and complex. It is questionable whether the debtors ever read them, understood them, or were told what they meant. Basically, the agreements in both Colorado and Minnesota told the clients that the lawyers would prepare and file bare-bones chapter 7 petitions, with no fees paid by the clients before filing.

The clients could elect after filing to sign post-filing retention agreements obliging the lawyers to provide all necessary services apart from adversary proceedings. The clients were also given the option to proceed *pro se* or hire another attorney.

The agreements did not disclose to the clients that both courts had local rules requiring the lawyers who filed the petitions to provide all required services (apart from adversary proceedings) until the court allows the lawyer to withdraw on motion, regardless of whether the client pays the fee after filing. Given the short deadlines for filing all required papers, a motion to withdraw would not be heard before the lawyer would have drafted and filed the remaining chapter 7 papers.

The Minnesota Opinion

In her May 19 opinion, Kesha L. Tanabe of St. Paul, Minn., found numerous “untrue and misleading statements” about the legal services in the retention agreements. For example, the agreements said that the lawyer’s services would terminate on filing, absent the client’s agreement to pay the fee after filing.

Referring to the court’s local rule, Judge Tanabe said,

Upon filing a petition, counsel agrees to represent the debtor and provide all reasonably necessary bankruptcy services throughout the case, until and unless permitted to withdraw through substitution or court approval, and authorization to withdraw is neither automatic nor presumed. An agreement that purports to withhold such services, or to condition such services upon execution of an additional fee agreement, is fundamentally untrue and misleading, in violation of § 526(a)(2) and (3).

Judge Tanabe said the agreement violated Section 526(a)(2)-(3) because it “affirmatively misrepresent[ed] well-settled law about withdrawal and the scope of services in bankruptcy cases.” She found another violation of Section 526(a)(3), because “the Agreements omit any explanation that counsel would not be permitted to withdraw from representation after filing a partial petition, absent truly extraordinary circumstances.”

Judge Tanabe went on to say that the “Agreements obscure the reality that execution of the Post-Petition Agreement was not necessary to ensure the provision of legal services in Debtor’s main case after filing the partial petition. In fact, the real purpose of the Post-Petition Agreement is to ensure the collectability of Applicant’s unpaid legal fees.”

Because the engagement agreements violated Sections 526(a)(2)-(3) and 528(a)(1)(A), Judge Tanabe held that they were “statutorily” void and unenforceable under Section 572(c)(1).

The Colorado Case

The case before Judge McNamara in Denver was similar, but the lawyer was factoring the receivables to be paid by the client in installments after filing.

Were the fee to be paid entirely after filing, the agreements required the client to pay almost $3,000, including the filing fee. If the fee were to be paid in full before filing, the fee would be about $2,000, not including the $335 filing fee.

Judge McNamara’s skepticism about the cost of the factoring agreement suggests that he might have nixed the fee arrangement on that basis alone. However, he found defects like those identified by Judge Tanabe, leading him to invalidate the fee arrangements without alluding to factoring.

The agreements in Denver contained a provision intended to skirt conflicts of interest. If the client decided not to pay the fee after filing, the agreements purported to say that the client waived the resulting conflict of interest when the lawyer would move to withdraw.

Judge McNamara found “numerous ways” in which the fee agreements were “false” or “misleading.” For example, the agreements didn’t mention the “numerous additional filings” that the lawyer would be required to prepare after filing under the local rule, even if the client did not agree to pay the fee.

Similarly, Judge McNamara said that the agreements failed to mention the client’s fourth option of having the lawyer “continue to represent her in all aspects of her Chapter 7 case *without* entering into a new Post-Filing Agreement.” [Emphasis in original.]

In Judge McNamara’s case, the lawyer advanced the $335 filing fee. He said that the retention agreement “misled [the client] into committing to repay the filing fee advanced by [the lawyer],” although the obligation to repay the filing fee had been discharged.

Having found that the agreements contained “misrepresentations” in violation of Sections 524, 526 and 528, Judge McNamara held that the agreements were “void” under Section 526(c)(1).

Judge McNamara said “there may be sound policy reasons supporting a bifurcated payment structure.” However, he said that the court “cannot legislate and cannot just make up a new policy framework for Chapter 7 debtor’s counsel fees.”

As remedy, Judge McNamara voided the retention agreements. Because the client had paid about $1,000 after filing, he required the lawyer to disgorge the payments to the chapter 7 trustee, who would turn over the disgorged fees to the debtor less whatever pre-filing tax refunds the debtor was entitled to receive.

Of *in terrorem* significance, Judge McNamara enjoined the lawyer “from making any of the misrepresentations or misleading statements identified in this Opinion in future Pre-Petition Agreements and Post-Petition Agreements in the District of Colorado.” Consequently, the lawyer would run the risk of being found in contempt were he to use a bifurcated fee agreement in the future that didn’t clearly tell the client there was no obligation to pay the fee after filing, among other things.

Observations

If there be a fault in either opinion, it may lie in the question of whether the local rules delve into substantive law beyond the courts’ rulemaking powers. In South Carolina, a district judge read a similar local rule as not raising a *per se* bar to bifurcated fee arrangements. *Benjamin R. Matthews & Assoc. v. Fitzgerald (In re Prophet)*, 21-01082, 2022 BL 84916, 2022 WL 766390 (D.S.C. Mar. 14, 2022).

However, the court in *Prophet* made no ruling about the reasonableness of the fees, the adequacy of disclosures or informed consent by the debtors regarding the fee structure. To read ABI’s report on *Prophet*, [click here](https://www.abi.org/newsroom/daily-wire/the-concept-of-bifurcated-fee-agreements-approved-on-appeal-in-south-carolina).

The opinions are [*In re Siegle*](https://abi-opinions.s3.amazonaws.com/Siegel.pdf), 21-42321 (D. Minn. May 19, 2022); and [*In re Suazo*](https://abi-opinions.s3.amazonaws.com/Suazo.pdf), 20-17836 (D. Colo. May 10, 2022).

#### Reversing the bankruptcy court, the district court decided that a local rule did not bar bifurcated fee arrangements altogether.

# The Concept of Bifurcated Fee Agreements Approved on Appeal in South Carolina

Reversing the bankruptcy court, a district judge in South Carolina permitted so-called bifurcated fee arrangements for chapter 7 debtors despite a local rule that could be read to bar them outright.

In her March 14 opinion, District Judge J. Michelle Childs seemed motivated by the realization that prospective chapter 7 debtors who can’t afford the entire fee before filing have no suitable alternatives, especially if they need bankruptcy relief quickly.

Judge Childs said,

Bifurcated agreements, when utilized properly and with sufficient safeguards, enable debtors who otherwise could not afford counsel to obtain legal services of an attorney to aid them in navigating the complex bankruptcy process.

The Bifurcated Fee Structure

When a client cannot pay the entire attorney’s fee before filing, a typical bifurcated arrangement entails two engagement agreements, one signed before filing and a second signed after filing. Clients pay nothing or a fraction of the ordinary fee before filing, with an explicit understanding that they are not required to hire the same lawyer for services after filing. The agreements explain what services the lawyer will provide before and after filing.

The attorney who brought three cases on appeal to Judge Childs ordinarily charged a fixed fee of $2,350 (including the filing fee) for clients who could pay before filing. On a sliding scale, the clients paid more when some or all of the fee was paid after filing.

A client who paid nothing before filing was obligated to pay $2,800 under the bifurcated arrangement. The lawyer justified the increase by the cost of factoring the receivable.

Based on a local rule, the U.S. Trustee filed a motion asking the bankruptcy court to cancel the bifurcated fee arrangements in three cases. The local bankruptcy rule provides that an attorney who files a petition is “the responsible attorney of record for all purposes . . . and in all matters arising in connection with the case . . . .”

The bankruptcy court granted the U.S. Trustee’s motion, holding that “bifurcated agreements are entirely impermissible” under the local rule, Judge Childs said.

The attorney appealed. Of perhaps no little import, Judge Childs said that the three debtors “obtained satisfactory results” and said in depositions that they appreciated the chance to have bifurcated arrangements.

The lawyer won on appeal.

A ‘Charitable’ Interpretation of the Local Rule

Judge Childs found no “binding precedent where a court determined that bifurcated fee agreements like those at issue were prohibited as a matter of law.”

However, Judge Childs did identify nonbinding decisions coming down both ways. She said that “many courts faced with similar agreements have found that bifurcated fee agreements are not prohibited *per se*, but that the agreements before the court were either improper under the applicable rules or that the court could not determine their propriety based on the record.”

Among the courts that have permitted bifurcated fee agreements, Judge Childs cited *In re Carr*, 613 B.R. 427 (Bankr. E.D. Ky. 2020). The *Carr* court, she said, found that “dual contracts satisfied the requirements of the Bankruptcy Code, the Bankruptcy Rules, and applicable ethical rules.” *Id*. at 436. To read ABI’s report on *Carr*, [click here](https://www.abi.org/newsroom/daily-wire/another-court-approves-an-arrangement-for-paying-most-chapter-7-fees-after).

Judge Childs said she was “persuaded by the reasoning” in *In re Hazlett*, No. 16-30360, 2019 WL 1567751 (Bankr. D. Utah Apr. 10, 2019), a case where the bankruptcy court had a similar local rule. To read ABI’s report on *Hazlett*, [click here](https://www.abi.org/newsroom/daily-wire/bifurcated-fees-for-destitute-chapter-7-debtors-approved-in-utah).

Like *Hazlett*, the attorney on appeal to Judge Childs conceded that he was the attorney of record until allowed by the court to withdraw.

Reading the local rule to bar bifurcated arrangements entirely “would undermine the very purpose of the Rule,” Judge Childs said. Assuming there are safeguards, a bifurcated agreement permits a debtor who cannot pay a retainer to have counsel “in navigating the complex bankruptcy process,” she said.

Reversing and remanding, Judge Childs ended her opinion by noting that the local rule was the only issue on appeal. She made no ruling about the reasonableness of the fees, the adequacy of disclosures or informed consent by the debtors regarding the fee structure.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Prophet.pdf) *Benjamin R. Matthews & Assoc. v. Fitzgerald (In re Prophet)*, 21-01080 (D.S.C. March 14, 2022).

#### Curiously, bifurcated fee arrangements are sometimes permitted in the Eastern District of Kentucky.

# Bifurcated Fee Arrangements Barred in Western District of Kentucky

The bankruptcy judges in the Western District of Kentucky have effectively banned so-called bifurcated fee arrangements where chapter 7 debtors pay counsel fees after filing. The October 5 opinion by Bankruptcy Judge Joan A. Lloyd of Louisville, Ky., also bars lawyers from advancing the filing fee before filing and collecting the filing fee after filing.

Although the decision by Judge Lloyd largely follows holdings by Bankruptcy Judge Laurel M. Isicoff of Miami, Judge Lloyd declined to adopt Judge Isicoff’s decision to allow bifurcated fee arrangements so long as disclosures are up to snuff. *See* *In re Brown*, 631 B.R. 77 (Bankr. S.D. Fla. June 16, 2021). To read ABI’s report on *Brown*, [click here](https://www.abi.org/newsroom/daily-wire/standards-laid-down-for-bifurcated-fee-arrangement-in-the-southern-district-of).

Judge Lloyd declined to follow one of her sister judges from the Eastern District of Kentucky who allowed the use of bifurcated fee arrangements in certain delineated circumstances. *See* *In re Carr*, 613 B.R. 427 (Bankr. E.D. Ky. 2020). To read ABI’s report on *Carr*, [click here](https://www.abi.org/newsroom/daily-wire/another-court-approves-an-arrangement-for-paying-most-chapter-7-fees-after).

Judge Lloyd discussed the issue with the other judges in her district, who agreed that her legal conclusions would be the opinion of all judges in the district.

The Arrangement to Pay Fees After Filing

The fee bifurcated arrangement on review by Judge Lloyd was the most aggressive that a debtor’s lawyer could employ. The arrangement was designed as an end run on *Lamie v. U.S. Trustee*, 540 U.S. 526, 538 (2004), where the Supreme Court held that a chapter 7 lawyer cannot require the debtor to pay for post-petition services after filing if the obligation arose pre-petition.

Judge Lloyd was reviewing a dozen chapter 7 cases filed by the same lawyer. The debtor-clients paid nothing before filing. The lawyer even advanced the filing fee before filing.

The client signed two engagement agreements, one before filing and one afterward. Under the prefiling agreement, the client paid nothing. However, the lawyer interviewed the client, prepared and filed the petition, paid the filing fee and filed a list of creditors. The client was not obligated to sign a post-filing engagement agreement.

When the client signed the post-filing agreement, the lawyer became obligated to prepare and file the other required documents and attend the meeting of creditors. The post-filing agreement did not require the lawyer to appear in adversary proceedings.

Under the post-filing agreement, the client became obligated to pay a total of $2,500 in monthly installments in the first year after filing. In addition to the lawyer’s services, the payments covered the $335 filing fee paid by the lawyer before filing.

Unknown to the client, the lawyer had a factoring agreement with a secured lender. Immediately after filing, the lender would pay the lawyer 60% of the $2,500 fee. The lender collected the client’s monthly payments and had a security interest in the lawyer’s receivables.

For its services, the lender was entitled to retain 25% of collections from the client. The lender retained another 15% of the fee to cover its advances under the $50,000 line of credit with the lawyer.

In her opinion, Judge Lloyd said that the same lawyer “consistently charged” a $1,250 flat fee for clients who paid the entire fee before filing.

After an initial hearing about the fee arrangements, Judge Lloyd required the lawyer to seek an ethics opinion from the Kentucky Bar Association. The bar group declined to offer an opinion, for a variety of reasons.

The fee and factoring arrangements failed on many levels. Judge Lloyd found multiple violations of the Bankruptcy Code, the Bankruptcy Rules and the Kentucky Rules of Professional Conduct.

Lawyer Can’t Walk Away After Filing the Petition

Judge Lloyd said that the factoring agreement was “clearly designed to defeat existing bankruptcy law and rules enacted over at least a century ago to protect debtors, and all the machinations inherent in its processes will not save it from review and censure. Further, the Kentucky Rules of Professional Conduct are no less forgiving to counsel.”

Judge Lloyd was no less critical about the notion that the lawyer has no obligations after filing if the client declines to sign a post-filing engagement agreement. Under the local rules, she said that filing the petition obligated the lawyer to perform all services in the ensuing chapter 7 case. In other words, the client’s failure to sign the post-petition engagement agreement could not relieve the lawyer from the obligation to prepare and file the remaining required papers and represent the client in the chapter 7 case, other than in adversary proceedings.

Furthermore, the client’s obligation to repay the $335 filing fee after filing was a discharged debt that the lawyer could not collect after filing.

More particularly, Judge Lloyd held that advancing the filing fee and the concomitant repayment obligation in the post-filing agreement violated both the Bankruptcy Code and the Kentucky ethics rules. In addition to violating the automatic stay and the discharge injunction, advancing the filing fee violated Section 526(a)(4), because the lawyer was advising the client to incur more debt in advance of bankruptcy.

Judge Lloyd saw a “serious conflict of interest” when the lawyer asked the client to sign the post-petition agreement although the lawyer was already obligated to perform the post-filing services and was barred from collecting the filing fee.

Judge Lloyd concluded that the lawyer made inadequate disclosure about the bifurcated agreement and none regarding the factoring arrangement. She said, among other things, that the client was paying far more for representation and had no role in negotiating the factoring costs that raised the price for the debtor. The failure to disclose the factoring agreement was “[p]articularly troublesome,” Judge Lloyd said.

Judge Lloyd concluded that the factoring agreement violated the Bankruptcy Code, the Bankruptcy Rules, the local rules, and the state’s ethics rules. With regard to the factoring agreement, Judge Lloyd said “it is doubtful that any amount of disclosure can remedy the problem.”

Judge Lloyd also identified undisclosed fee-splitting as a consequence of the factoring agreement, a failure of disclosure in the lawyer’s Rule 2016 disclosure, and a violation of Section 329. She said that the failure to disclose was “particularly troubling” because the client was being charged “a higher fee” than someone who paid in advance of filing.

Finally, Judge Lloyd held that the fee was not “reasonable,” given the $1,250 flat fee the same lawyer would charge clients who paid in advance of filing.

Judge Lloyd said that similar arrangements may not be used “by any attorney” in the district.

For a client who can’t pay the filing fee in advance of filing, Judge Lloyd noted at the end of her opinion that debtors may pay the filing fee in installments or ask for a waiver of the fee. To pay counsel fees after filing, she said that debtors can use chapter 13.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Baldwin.pdf) *In re Baldwin*, 20-10009 (W.D. Ky. Oct. 5, 2021).District judge in Idaho finds no ambiguity in a statute that doesn’t explicitly say whether a chapter 13 trustee is paid if the case is dismissed before confirmation.

# District Court Says Chapter 13 Trustee Is Paid Even if Dismissal Precedes Confirmation

A standing chapter 13 trustee in Idaho twice appealed the denial of her fees because the cases were dismissed before plan confirmation. She won both times, once in the Bankruptcy Appellate Panel in July and now in district court.

In a 2/1 nonprecedential opinion, the Ninth Circuit Bankruptcy Appellate Panel reversed and ruled that the trustee was entitled to her fee. *See* *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 BL 276666, 2021 Bankr Lexis 1960, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/chapter-13-trustees-are-paid-even-if-dismissal-comes-before-confirmation-bap).

Courts around the country are split; there is no authority from a circuit court, and the facts are always the same: A chapter 13 case is dismissed before plan confirmation, and the bankruptcy court must decide whether the standing trustee is entitled to her or his fee.

In the case on appeal to Chief District Judge David C. Nye of Boise, Idaho, the bankruptcy court had decided that the statutes were ambiguous and concluded that a chapter 13 trustee is paid only if a plan is confirmed. *See* In re Evans, 615 B.R. 290 (Bankr. D. Idaho Feb. 13, 2020). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/no-fees-for-a-chapter-13-trustee-in-a-case-dismissed-before-confirmation/).

Judge Nye reversed on February 8. His 15-page opinion takes a refreshingly different approach to answering the question.

The Pertinent Statutes

28 U.S.C. § 586(e) says that a standing trustee “shall *collect* such percentage fee from all payments . . . under [chapter 13] plans. . . .” [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor “shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b).” The subsection says nothing explicitly about the standing trustee’s fee.

Chapter 12 and Subchapter V of chapter 11 explicitly say what happens when dismissal precedes confirmation. Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed, and Section 1194(a) allows a Subchapter V trustee to be paid if the case is dismissed before confirmation.

No Statutory Ambiguity

Judge Nye saw no ambiguity in Section 586(e). He looked at the statute word by word.

The first pertinent phrase, “shall collect,” Judge Nye said, “conveys something final. There is no condition or exception — collect it and its yours.” Collectors, he said, “are not in the business of returning payments.” When Congress wants a collection to be conditional or reversible, it says so.

Judge Nye said that the second phrase, “‘from all payments’ [,] . . . does not limit the percentage fees to those taken from payments received after confirmation. Section 586(e)(2), by itself, does not express any exception to collecting the percentage fee.”

The third phrase is “under plans.” Judge Nye said that the “statute places no limitations or exceptions on which plans are subject to the percentage fee. This generalization of ‘plans’ includes confirmed, not yet confirmed, and denied plans. If there is a plan, there is also a percentage fee.”

The fourth phrase is “serves as the standing trustee.” Judge Nye noted that the trustee serves before plan confirmation. “She gets the percentage fee as payment for her work as the standing trustee — not only for the work of the standing trustee after plan confirmation,” he said.

Judge Nye concluded that Section 586(e)(2) “is plain and unambiguous.” It has no “further qualifiers, limitations or exceptions.” Because “the fee is already paid to Trustee before confirmation, § 1326(a)(2) does not direct the Trustee to return it if confirmation does not happen.”

Judge Nye found ambiguity “only when you look to § 1226 and see that it directs the standing trustee in chapter 12 bankruptcy cases to retain the percentage fee, which is superfluous if § 586(e)(2) already directs the same. Thus, it is inappropriate to apply the rule against surplusage to alter the plain language of § 586(e)(2).”

Judge Nye said that the debtor and the trustee both had “sensible arguments” about policy. “However,” he said, “the Debtors’ arguments have failed to overcome or cast into doubt the plain language of § 586(e)(2).”

Judge Nye reversed and remanded for the bankruptcy court to enter an order allowing the trustee to retain her fee.

[The opinion is](https://abi-opinions.s3.amazonaws.com/McAllister.pdf) *McCallister v. Evans*, 20-00112 (D. Idaho Feb. 8, 2022).

#### The Ninth Circuit BAP joins the minority on an issue that’s headed for the court of appeals.

# Chapter 13 Trustees Are Paid Even if Dismissal Comes Before Confirmation, BAP Says

In a split decision, the two judges on the Ninth Circuit Bankruptcy Appellate Panel took sides with the minority of courts around the country by ruling in a nonprecedential opinion that a standing chapter 13 trustee is entitled to retain her fee if the case is dismissed before confirmation.

All three judges on the panel offered their opinions. Bankruptcy Judge Gary A. Spraker wrote a concurring opinion to support the majority opinion by Bankruptcy Judge Scott Gan. Bankruptcy Judge William J. Lafferty penned a dissent. The three opinions consume 53 pages.

Combined, the opinions are the best exposé so far on both sides of the question. The opinions are a particularly fine discussion of the plain meaning doctrine, and when or whether it should be the end of the discussion. The opinions on both sides also analyze every conceivable canon of statutory construction applicable to the issue.

Typical Facts

A couple filed a chapter 13 petition in December 2019. Four months later, the court granted their voluntary motion to dismiss. On dismissal, the trustee was holding about $2,200. No one objected to the allowance and payment of the debtors’ counsel fee of some $1,800.

The bankruptcy court struck language in the proposed dismissal order that would have allowed the standing chapter 13 trustee to take her fee from the remaining $400. Instead, the bankruptcy judge ruled in substance that the trustee was not entitled to her fee because the case was dismissed before confirmation.

As authority, the bankruptcy court cited In re Evans, 615 B.R. 290 (Bankr. D. Idaho Feb. 13, 2020), by Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho. To read ABI’s report on Evans, [click here](https://www.abi.org/newsroom/daily-wire/no-fees-for-a-chapter-13-trustee-in-a-case-dismissed-before-confirmation/). *Evans* was appealed, but there is no decision as yet.

Likely more concerned about the precedent than the $400, the chapter 13 trustee appealed and won in a 2/1 decision.

The Dueling Statutes

28 U.S.C. § 586(e) says that a standing trustee “shall *collect* such percentage fee from all payments . . . under [chapter 13] plans. . . .” [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor “shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b).” The subsection says nothing explicitly about the standing trustee’s fee.

To add further confusion, chapter 12 and Subchapter V of chapter 11 explicitly say what happens when dismissal precedes confirmation. Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed, and Section 1194(a) allows a Subchapter V trustee to be paid if the case is dismissed before confirmation.

What’s to be taken from chapter 13’s failure to say explicitly whether a trustee is paid if the case is dismissed before confirmation?

The Majority Opinion – No Ambiguity – 28 U.S.C. § 586(e) Controls

Judge Gan found no ambiguity in the statutes. He held that “a standing trustee is entitled to collect the statutory fee under § 586(e) upon receipt of each payment under the plan and is not required to disgorge the fee if the case is dismissed prior to confirmation.” He also held that the standing trustee “obtains ownership of her percentage fee” when the debtor makes a payment under the plan.

In addition to what he said was the “common sense” and controlling meaning of “collect,” Judge Gan pointed out how a standing trustee’s compensation is controlled entirely by Section 586(e). The court has no control over the amount or payment via Section 330.

Simply stated, Judge Gan said “that the plain meaning of ‘shall collect such percentage fee’ means that a standing trustee obtains the fee upon receipt of each plan payment.”

Judge Gan reversed and remanded, devoting much of his opinion to explaining why Section 1326(a)(2) was not pertinent.

Concurring, Judge Spraker said that a chapter 13 trustee’s fee is akin to a “user fee,” where “payment does not depend upon the success of the endeavor that generates the fee.” Mirroring Judge Gan and disagreeing with *Evans*, he said that “the trustee is entitled to her fee as she receives the debtor’s plan payments whether that plan is confirmed or not.”

Judge Spraker said he did not base his conclusion on the idea that a standing chapter 13 trustee should be paid for her services regardless of whether the plan is confirmed. Rather, he agreed with Judge Gan “because I find [his] reasoning more natural and less damaging statutorily to give effect to the plain and ordinary meaning of § 586(e).”

The Dissent

From a “purely policy standpoint,” Judge Lafferty said in his dissent that he would agree with the majority and pay the chapter 13 trustee. However, he gave weight to the different result that Congress has mandated for chapter 12 and Subchapter V cases.

Judge Lafferty said he disagreed “vigorously” with the idea that the conclusion is found in the “‘unambiguous’ language in one provision of what [the majority] believes to be the only relevant statute.”

Judge Lafferty was not inclined to ignore legislative history. The House Report said that the fee is “fixed” by Section 586(e) but is payable under Section 1326(a)(2). Judge Lafferty’s dissent is an admirable survey of theories about when the plain meaning doctrine should or should not be invoked.

Recommendation and Observations

For anyone confronting the issue, the BAP opinion and *Evans* have everything there is to say.

There likely will be no appeal to the Ninth Circuit from the BAP opinion because the debtor was not motivated to appear on the first level of appeal. With only $400 in the balance, the debtor is not likely to appeal to the circuit.

However, *Evans* is *sub judice* in district court. Odds are, there will be an appeal to the circuit regardless of the outcome.

We salute the BAP for making its decision nonprecedential. Although BAP opinion are not binding except in the case on appeal, making the opinion nonprecedential signals to bankruptcy judges throughout the Ninth Circuit that they are at liberty to rule on the issue as they see fit.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Harmon.pdf) *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 BL 276666, 2021 Bankr Lexis 1960 (B.A.P. 9th Cir. July 20, 2021).

#### A chapter 13 trustee is not a federal employee for the purposes of the Federal Tort Claims Act.

# ‘13’ Trustees Are Paid Even if Dismissal Comes Before Confirmation, District Judge Says

Upholding Bankruptcy Judge Robert E. Grossman, a district judge in Brooklyn, N.Y., ruled that a chapter 13 trustee is entitled to compensation if the case is dismissed before confirmation.

In most chapter 13 cases, the money held by the trustee is so small that it’s not worth litigating whether the trustee is entitled to payment if the dismissal precedes plan confirmation. No so in the case that was before Judge Grossman in Central Islip, N.Y.

The debtor filed a chapter 13 plan where she paid the trustee $362,000 in a lump sum. Thirteen months later, the debtor voluntarily dismissed the case. After dismissal, the trustee returned about $341,500 to the debtor but retained some $20,500 as his fee.

The debtor filed a motion asking the court to require the trustee to disgorge the fee. Judge Grossman rebuffed all of the debtor’s arguments, finding no ambiguity in the statutes. *In re Soussis*, 624 B.R. 559 (Bankr. E.D.N.Y. Nov. 12, 2020). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/courts-split-on-paying-chapter-13-trustee-fees-in-cases-dismissed-before).

The debtor appealed. In a tightly worded opinion on January 24, District Judge Joan M. Azrack affirmed Judge Grossman’s holdings.

The principal issue revolved around three statutory provisions.

28 U.S.C. § 586(e) says that a trustee “shall *collect* such percentage fee from all payments . . . under [chapter 13] plans . . . .” [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing.

Subsection (a)(2) provides that payments made by the debtor “shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid . . . to creditors . . . , after deducting any unpaid claim allowed under section 503(b).”

Subsection (a)(2) says nothing explicitly about the trustee’s fee if the case is dismissed before confirmation.

Recognizing that not all courts agree, Judge Azrack said that she concurred “with the Bankruptcy Court’s well-reasoned interpretation that Section 586 entitles the Chapter 13 Trustee to ‘collect[] his percentage fee regardless of whether the plan is confirmed’ and that this interpretation of Section 586 is consistent with 11 U.S.C. § 1326.”

Judge Azrack cited a split decision by the Ninth Circuit Bankruptcy Appellate Panel as “further [support for] this interpretation.” *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021). To read ABI’s report on *Harmon*, [click here](https://www.abi.org/newsroom/daily-wire/chapter-13-trustees-are-paid-even-if-dismissal-comes-before-confirmation-bap).

Like Judge Grossman, Judge Azrack concluded that the debtor had no claim under the Federal Tort Claims Act, because the debtor failed to exhaust her administrative remedies.

Judge Azrack also said that the FTCA only applies to federal employees, and that the chapter 13 trustee “is not an employee of the government.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Soussis+Dist+Ct+Affirmance.pdf) *Soussis v. Macco*, 20-05673 (E.D.N.Y. Jan. 24, 2022).

#### ***District judge in Colorado sides with the majority and doesn’t allow a chapter 13 trustee to be paid if dismissal occurs before plan confirmation.***

# On a Split, District Judge Doesn’t Pay ‘13’ Trustee if Dismissal Precedes Confirmation

On a question where the lower courts are split, District Judge R. Brooke Jackson of Denver sided with the majority, reversed the bankruptcy court and held that a chapter 13 trustee is not entitled to be paid if the case is dismissed before confirmation of a plan.

The debtor filed a chapter 13 petition in 2017. The bankruptcy court dismissed the case in 2020 because the debtor never confirmed a plan. While the case was pending, the debtor had paid the chapter 13 trustee almost $30,000.

Following dismissal, the chapter 13 trustee paid the debtor’s counsel almost $20,000 on an allowed fee application and distributed another $7,500 in payment of a priority tax claim. Toward partial payment of the chapter 13 trustee’s fee, the bankruptcy court allowed the trustee to retain the remainder, some $2,600.

With the $2,600 in controversy, the debtor appealed. Judge Jackson reversed in an opinion on December 6.

The Statutes

Arguably, the statutes don’t have an explicit answer to whether the trustee gets paid if dismissal precedes confirmation.

28 U.S.C. § 586(e) says that a standing trustee “*shall* *collect* such percentage fee from all payments . . . under [chapter 13] plans. . . .” [Emphasis added.]

Section 1326(a)(1) requires a chapter 13 debtor to commence making payments to the trustee within 30 days of filing. Subsection (a)(2) provides that payments made by the debtor “shall be retained by the trustee until confirmation or denial of confirmation. . . . If a plan is not confirmed, the trustee shall return any such payments not previously paid and not yet due and owing to creditors pursuant to paragraph (3) to the debtor, after deducting any unpaid claim allowed under section 503(b).”

The subsection has nothing explicit to say about the standing trustee’s fee if dismissal precedes confirmation.

However, Chapter 12 and Subchapter V of chapter 11 explicitly say what happens when dismissal precedes confirmation. Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed, and Section 1194(a) allows a Subchapter V trustee to be paid if the case is dismissed before confirmation.

Absence of Specific Language Was Pivotal

Judge Jackson found no controlling authority in the Tenth Circuit. He did cite the recent decision by the Ninth Circuit Bankruptcy Panel in a 2/1, nonprecedential opinion that a chapter 13 trustee is paid if dismissal comes before confirmation. *McCallister v. Harmon (In re Harmon)*, 20-1168, 2021 WL 3087744 (B.A.P. 9th Cir. July 20, 2021).

*Harmon* contains a lengthy compendium of every argument on both sides of the issue. To read ABI’s report on *Harmon*, [click here](https://www.abi.org/newsroom/daily-wire/chapter-13-trustees-are-paid-even-if-dismissal-comes-before-confirmation-bap).

Inhis five-page opinion, Judge Jackson said that Section 586 “could be read as implying that the collected fee may be retained regardless of whether the plan is confirmed.”

“However,” Judge Jackson said, “it does not expressly address the question, and I conclude that it does not compel that result.”

“If the payments must be returned” under Section 1326(a)(2), “it follows that fees collected from such payments must be returned,” Judge Jackson said.

Judge Jackson noted there was no language in Section 1326(a)(2) requiring payment to the trustee that is comparable to the language in chapter 12 mandating payment.

Judge Jackson quoted the *U.S. Trustee’s Handbook* calling for the return of the fee “if there is controlling law in the district requiring such reversal.”He declined “to apply *Chevron* deference, because I conclude that the answer can be found in the language of the statutes.”

While reversing the bankruptcy court’s order that allowed the trustee to retain the fee, Judge Jackson said that he “might” prefer, “as a policy matter, . . . that the trustee be fairly compensated for his efforts.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Doll.pdf) *Doll v. Goodman (In re Doll)*, 21-00731 (D. Colo. Dec. 6, 2021).

#### Judge Jacobvitz told counsel for chapter 13 debtors how to write their engagement agreements to ensure being paid from funds held by the trustee if the case converts to chapter 7 before confirmation.

# Judge Tells ‘13’ Debtors’ Counsel How to Write their Retention Agreements

Debtors’ counsel have a problem. If a case *converts* to chapter 7 before confirmation of a chapter 13 plan, they might not be paid.

If a chapter 13 case is *dismissed* before confirmation, Section 1326(a)(2) says that the trustee pays administrative expenses (such as allowed counsel fees) before the remainder is returned to the debtor. However, the statute doesn’t say how or whether debtor’s counsel is paid if the case *converts* to chapter 7 before confirmation.

Previously, Bankruptcy Judge Robert H. Jacobvitz of Albuquerque, N.M., held that counsel are not paid if the case *converts* before confirmation. He found a solution, however.

Chapter 13 debtor’s counsel should include a provision in the retention agreement assigning funds in the trustee’s possession to the lawyer to the extent of the lawyer’s allowed fees, in the event that the case *converts* to chapter 7 before confirmation.

Conversion to ‘7’ Before ‘13’ Confirmation

A couple’s chapter 13 case was on the verge of dismissal or conversion to chapter 7 before confirmation of a chapter 13 plan. The debtors’ counsel had withdrawn, but Judge Jacobvitz had granted a fee application by the debtors’ counsel. Following Section 1326(a)(2), it called for the chapter 13 trustee to pay the lawyer’s allowed compensation if the debtors were to elect having their case *dismissed*.

The fee order was silent about how or whether the allowed fees would be paid if the debtors elected for *conversion* to chapter 7.

That’s what happened. The case *converted* to chapter 7, and Judge Jacobvitz was tasked with deciding whether there were any circumstances under which the debtors’ counsel could be paid. In other words, could counsel be paid, or was Judge Jacobvitz compelled to return everything to the debtors that was being held by the chapter 13 trustee?

*Harris v. Viegelahn*, 575 U.S. 510 (2015), did not provide an answer but may have suggested the outcome, although adverse to counsel. In *Viegelahn*, the chapter 13 plan had been confirmed, but the case later converted to chapter 7. The disposition of the money held by the chapter 13 trustee was not answered by Section 1326.

The Supreme Court held that undistributed money goes back to the debtor. After conversion, the Court also said that the services of the chapter 13 trustee terminate and that “no Chapter 13 provision holds sway.” *Id*. at 520.

In 2015 after *Viegelahn*, Judge Jacobvitz and his colleague on the Albuquerque bench, Bankruptcy Judge David T. Thuma, ruled together that the court cannot pay counsel fees if the case converts to chapter 7 before confirmation. *See* *In re Beauregard*, 533 B.R. 826, 832 (Bankr. D.N.M. 2015). However, Judge Jacobvitz cited judges from elsewhere who found reasons for paying counsel in a case converted to chapter 7 before confirmation.

Judge Jacobvitz found a method for (sometimes) paying counsel by following *dicta* in *Beauregard*.

Paraphrasing *Beauregard*, Judge Jacobvitz said that a “possible way” to pay counsel would be the inclusion “in [the lawyer’s] engagement letter [of] an assignment of such funds to debtor’s counsel.” In his November 12 opinion, he held “that such an assignment is permissible.”

*Viegehahn* was no roadblock, Judge Jacobvitz said, because he was giving no effect to any provision in chapter 13, nor was he calling on the chapter 13 trustee to carry out a chapter 13 service. Instead, he was only directing the chapter 13 trustee to “honor the private agreement” between the debtors and their counsel.

Of greater significance, Judge Jacobvitz said he was furthering “an important public policy of giving individuals in financial distress who wish to take advantage of the chapter 13 fresh start access to counsel willing to represent them in a chapter 13 case with little or no upfront payment.”

Judge Jacobvitz cited Bankruptcy Judge David E. Rice for having agreed with the *dicta* in *Beauregard*. *See* *In re Brandon*, 537 B.R. 231, 236-37 (Bankr. D. Md. 2015).

Judge Jacobvitz told bankruptcy lawyers in New Mexico that an “assignment by the debtor to the debtor’s bankruptcy counsel of the debtor’s right to payment from the chapter 13 trustee upon conversion to chapter 7 may be included in the engagement letter by which the debtor retained bankruptcy counsel.”

In the case before him, the retention agreement was not in the record. If debtors’ counsel were to file the agreement with the court, and if it had an assignment, Judge Thuma directed the chapter 13 trustee to pay the allowed fee and return the remainder to the debtors.

If the retainer agreement had no assignment, Judge Jacobvitz threw the lawyer a lifeline: The lawyer could have the client sign an assignment belatedly.

In an ordinary case, asking a client to sign an assignment after filing would be ethically “problematic,” Judge Thuma said. Because the lawyer had already withdrawn, he said there was not the same “inherent undue pressure.”

If the lawyer was to have the clients sign an assignment for the first time after conversion, Judge Thuma required counsel to file a certification to prove that the assignment was voluntary. The certification must read:

[The debtors] (1) understand that they are under no obligation to direct the former Chapter 13 Trustee to pay any moneys to [the lawyer], (2) understand that if the Chapter 13 Trustee does not pay monies she has on hand to the [lawyer,] she will refund the monies to [the debtors], and (3) of their own free will, and without any duress or pressure, direct the Chapter 13 Trustee to pay the monies she has on hand to the [the lawyer] up to the amount of the court-allowed unpaid compensation, with any excess funds returned to the [the debtors].

[The opinion is](https://abi-opinions.s3.amazonaws.com/McCune.pdf) *In re McCune*, 20-12326 (Bankr. D.N.M. Nov. 12, 2021).

### Judicial Liens

#### The City of Chicago argued unsuccessfully that liens on cars are statutory because they arise automatically when the car is impounded.

# Liens on Impounded Cars Are Judicial Liens that May Be Avoided, Seventh Circuit Says

The lien on an impounded car in Chicago is a judicial lien that a debtor may avoid as an impairment of an exemption under Section 522(f), according to the Seventh Circuit.

In ruling on April 21 that the lien was judicial, not statutory, the Seventh Circuit may or may not have created a split with the Third Circuit. We doubt the Supreme Court will be inclined to grant *certiorari* because the liens were based on dissimilar statutes.

A chapter 7 debtor in Chicago had more than $12,000 in parking tickets and other charges on an impounded car that was worth maybe $3,000. The bankruptcy court ruled that it was a judicial lien that the debtor could avoid, because the lien was inextricably tied to prior quasi-judicial proceedings.

The district court affirmed. *See* *City of Chicago v. Howard*, 625 B.R. 384, 390 (N.D. Ill. 2021), for a similar case where the district court affirmed. To read ABI’s report on *Howard*, [click here](https://www.abi.org/newsroom/daily-wire/debtors-win-in-district-court-they-can-avoid-judicial-liens-on-impounded-cars).

As a test case, the city appealed the decision involving the debtor with the $3,000 car and $12,000 in tickets. Circuit Judge David F. Hamilton upheld the two lower courts.

Both sides agreed that the debtor was entitled to avoid the lien if it were found to be judicial. The categorization of the lien was the only issue before the Seventh Circuit.

To rule, Judge Hamilton founded his decision on the definitions of judicial and statutory liens in Sections 101(36) and (53). The statute says that a judicial lien “means [a] lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding.”

The definition of statutory lien is more complex. It “means [a] lien arising solely by force of a statute on specified circumstances or conditions . . . but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.”

Focusing on the “distinctive language” in the two definitions, Judge Hamilton said that the word “solely” seems “clear enough and signals that prior legal proceedings leading to a lien would exclude the lien [on the debtor’s car] from the category of statutory liens.” He cited the Senate and House Reports for saying that a “‘statutory lien is only one that arises automatically, and is not based on an agreement to give a lien or on judicial action.’”

Next, Judge Hamilton laid out the complex quasi-judicial procedures that the city must undertake before impounding a car. Among other things, he said that “several legal proceedings had to be completed before impoundment.” At the moment the city boots or hauls the car away, the possessory lien attaches.

Judge Hamilton distinguished a mechanics’ lien from the lien on an impounded car. In the case of a statutory mechanics’ lien, it arises automatically by statute when the debtor fails to make a payment.

For Judge Hamilton, “the substantial quasi-judicial proceedings needed for the City to obtain an impoundment lien” were “decisive.”

Hoping to persuade the circuit to the contrary, the city contended that the lien was statutory because it arose automatically upon impoundment and without further judicial or quasi-judicial action.

Judge Hamilton was not persuaded. He said, “we do not think we can ignore all the prior legal process that must occur before the City’s possessory lien arises.” He refused to regard the prior processes as “irrelevant.”

The relevant inquiry, Judge Hamilton said, “is not whether a statute authorizes or governs the lien but what is necessary for the lien to arise.”

The city contended that upholding the lower courts would create a split with the Third Circuit where the Philadelphia-based appeals court was ruling on a New Jersey statute. Judge Hamilton said there was a “critical difference” in the procedures that made the statutes “markedly different.”

The city next argued that affirming would turn tax liens into avoidable judicial liens.

Judge Hamilton said that tax liens are “unquestionably statutory,” because “Congress is entitled to single out a particular category of liens and classify it accordingly. We do not disturb that prerogative or conclusion with this opinion.”

Judge Hamilton upheld the lower courts and ruled that the lien was judicial because it did “not arise solely by statute.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/Mance.pdf) *City of Chicago v. Mance (In re Mance)*, 21-1355 (7th Cir. April 21, 2022).

### Estate Property

#### In a nonprecedential opinion, the Fifth Circuit suggests that a mortgage that could be reformed in state court cannot be reformed in bankruptcy.

# Fifth Circuit Majority Bars Reforming Mortgages in Bankruptcy

In a 2/1 opinion, the Fifth Circuit seemed to hold that a bankruptcy court cannot reform a mortgage to account for a mistake in drafting. In other words, any defects in a mortgage on the filing date, even though they might be corrected in state court outside of bankruptcy, are set in stone as a consequence of the so-called strong-arm clause in Section 544(a).

The dissenter would have reversed and remanded, to permit the bankruptcy court to entertain parol evidence aimed at reforming the mortgage.

The *per curiam* opinion by the majority was nonprecedential. Consequently, there is no binding precedent in the Fifth Circuit disallowing the bankruptcy court from reforming an instrument.

The majority were Circuit Judges Edith H. Jones and Stuart Kyle Duncan. Circuit Judge Stephen A. Higginson “respectfully” dissented.

The Defective (?) Mortgage

An individual was the sole owner and manager of a corporation that ended up being a chapter 11 debtor. The owner was not in bankruptcy.

Before bankruptcy, the owner took down an $8 million loan from a lender. Alongside the note and loan agreement, the owner, in his corporate capacity, signed a mortgage in favor of the lender secured by the company’s property.

The lender never made any loans to the corporation, only to the owner personally. In short, the mortgage secured any debt owing by the corporation to the lender, but there was no such debt.

In this writer’s view, there is some indication in the loan documents that the mortgage was also intended to secure the owner’s debt to the lender but was mistakenly written only to secure debt owing by the corporation.

In chapter 11, a different creditor with a lien on the corporation’s property objected to the validity of the lender’s mortgage and claim. The lender attempted to introduce parol evidence to say that the mortgage on the corporation’s property was intended to secure the owner’s debt.

Refusing to hear parol evidence, the bankruptcy court held that the mortgage was unenforceable because there was no underlying debt. On appeal, the district court upheld the invalidation of the mortgage and the disallowance of the lender’s claim against the corporation.

The Majority’s Affirmance

The majority said that the lender “essentially seeks to reform the publicly recorded Mortgage to cover [the owner’s] substantial debt.” The majority went on to say in the next breath that what the lender “does not do is grapple with the iron rule of bankruptcy: creditor claims are fixed for allowance purposes as of the date of filing of the debtor’s petition. *See* 11 U.S.C. §§ 506(b), 502(b)(1), 544(a).”

Continuing the same train of thought, the majority said that the “strong-arm power enables the Trustee to marshal the assets of the debtor as they existed at the date of bankruptcy, and that date furnishes a stable backdrop for valuing the assets according to the priorities established by the Bankruptcy Code and state law.”

Having stated the principles, the majority said that the mortgage “was defective at the inception of bankruptcy because it reflected only an obligation to pay by [the corporation], yet the debtor [corporation] owed it nothing. Louisiana law renders unenforceable such a mortgage that does not support an underlying obligation.”

The majority said it had not found a case even “remotely” similar where “a secured creditor was allowed to clean up its documentation and perfect an otherwise unenforceable claim post-bankruptcy.”

At the end of the opinion, the majority said,

The bankruptcy court acknowledged that parol evidence might have been admissible outside of bankruptcy to demonstrate the incompleteness of the Mortgage, but that exception does not come into play in this bankruptcy case, where the rights of other creditors are involved and the strong-arm clause takes effect.

Upholding the lower courts and insinuating that the result might have been different under Louisiana law, the majority said, “we need not consider whether the Mortgage also failed under the state’s recording law.”

The Dissent

In dissent, Judge Higginson cited testimony and indications in the loan documents that the mortgage may have been written in error. The lower courts, he said, did not consider parol evidence.

In Judge Higginson’s view, the failure to consider parol evidence was error because the rule in Louisiana law only prohibits contradictory testimony by one of the parties to the instrument. In the case on appeal, the parol evidence rule did not apply, in his view, because the mortgage was being challenged by another secured creditor who was not a party to the mortgage.

Judge Higginson would have reversed and remanded for a consideration of parol evidence. He did “not see the Bankruptcy Code as having relevance to the issue of whether the Mortgage is valid under Louisiana law, the only issue presented in this appeal.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/W+Resources.pdf) *NCC Financial LLC v. Investar Bank N.A. (In re W Resources LLC)*, 21-30291 (5th Cir. April 14, 2022).

#### The Tenth Circuit left an unanswered question: Do debtors retain post-filing appreciation in a home that is not sold before the case converts from chapter 13 to chapter 7?

# Tenth Circuit: Debtors Retain Appreciation in a Home Sold Before Conversion to ‘7’

One of the great unanswered questions in consumer law these days is whether appreciation in the value of a home becomes part of the chapter 7 estate if the case converts from chapter 13. The courts are split.

Affirming the bankruptcy court and the Bankruptcy Appellate Panel, the Tenth Circuit held that the appreciation in the value of a home sold after confirmation of a chapter 13 plan belongs to the debtor, not to creditors, if the case converts to chapter 7.

In the January 19 opinion by Chief Circuit Judge Timothy Tymkovich, the appeals court was careful to say that it was not ruling on what the result would be in a chapter 13 case converted to chapter 7 before the home was sold.

The Facts

A couple filed a chapter 13 petition and confirmed their plan in 2016. The plan cured arrears on their home mortgage, and the debtors were making payments directly to the mortgagee on the regular monthly payments.

In the petition, the debtors listed the house with a value of about $396,000, subject to a mortgage for some $337,000. The Colorado homestead exemption at the time was $75,000, so they claimed that the equity of about $60,000 was exempt.

While current on their plan payments, the debtors sold the home in 2018 for $520,000, generating net proceeds of $140,000. Two weeks later, they converted the case to chapter 7. Having spent some of the proceeds, they were holding about $100,000 from the sale of the home on the date of conversion.

When the chapter 7 trustee let it be known that he considered the nonexempt portion of the proceeds to be estate property, the debtors attempted to reconvert the case to chapter 13, but the bankruptcy judge denied the motion. The trustee then filed a motion asking the court to compel the debtors to turn over the nonexempt portion of the proceeds.

The trustee stipulated that the value of the home on the original filing date was $396,000, the amount scheduled by the debtors.

Bankruptcy Judge Elizabeth E. Brown of Denver found the statute ambiguous and referred to legislative history. She ruled in favor of the debtor, reasoning that “property” as used in Section 348(f)(1)(A) does not include appreciation in the value of a home. The Bankruptcy Appellate Panel affirmed in an opinion by Bankruptcy Judge Terrence L. Michael, but the trustee appealed. *See* *In re Barrera*, 620 B.R. 645 (Bankr. D. Colo. 2020); and *Rodriguez v. Barrera (In re Barrera)*, 20-003, 2020 BL 381720 (B.A.P. 10th Cir. Oct. 02, 2020). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/chapter-13-debtors-retain-appreciation-in-property-after-conversion-or-plan).

The Circuit’s Analysis

The pivotal statute is Section 348(f)(1), which underwent substantial amendment in 1994.

When a chapter 13 case converts to chapter 7, the section now provides that “property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion.”

The amendment was intended overrule caselaw holding that property obtained after filing a chapter 13 petition becomes estate property once the case converts to chapter 7.

Narrowing his holding to cases where the home was sold before conversion, Judge Tymkovich found the answer in the plain language of the statute, without need for analysis of legislative history.

Judge Tymkovich identified proceeds as a property interest different from the home itself. On the original chapter 13 filing date, there were no proceeds, only the home itself. “Based on the plain language of Section 348(f)(1)” — that estate property in a converted case is estate property “as of the date of filing of the petition” — he held that the sale proceeds “do not enter the converted Chapter 7 estate.”

Judge Tymkovich found support for his conclusion in other aspects of the statute’s plain language.

On conversion, the debtors no longer owned the home. Under the words of Section 348(f)(1), the home itself was not “under the control of the debtor on the date of conversion” and therefore was not estate property in chapter 7.

Judge Tymkovich saw additional support in Sections 1327(b) and 541(a)(6). Section 1327(b) automatically vests estate property in the debtor on confirmation of a chapter 13 plan, and under Section 541(a)(6), proceeds from estate property become property of the estate.

“Thus,” Judge Tymkovich said, “proceeds generated from the debtor’s property after confirmation do not become property of the estate as the underlying property no longer belongs to the estate.”

The Unanswered Question

Judge Tymkovich pointedly declined to say whether appreciation would have become property of the chapter 7 estate if there had been no sale of the home before conversion to chapter 7.

Had there been no sale, the home would have become estate property in chapter 7. Generally speaking, a chapter 7 trustee can sell a home and take proceeds into the estate in excess of encumbrances and the debtor’s exemption.

Given that the home and its proceeds would be estate property in chapter 7, it would seem that the trustee would retain appreciation. But perhaps that’s not the end of the story.

Assume the facts were like those in the Tenth Circuit appeal. That is to say, the chapter 13 debtors claimed an exemption in the entire equity. Further assume that there was no timely objection to the homestead exemption.

A debtor would argue that the chapter 7 trustee could not revisit the homestead exemption that supposedly locked in when there was no objection. It’s set in stone, the debtor would say, barring the chapter 7 trustee from claiming there were proceeds in excess of the homestead exemption.

On a question where the courts are split, the First Circuit has taken the position that a debtor’s homestead exemption, valid on the chapter 13 filing date, is not lost if the debtor sells the home but does not reinvest the proceeds within six months as required by state law. *See* *Rockwell v. Hull (In re Rockwell)*, 968 F.3d 12, 23 (1st Cir. 2020), *cert. denied*, 141 S. Ct. 1372 (2021). To read ABI’s report on *Rockwell*, [click here](https://www.abi.org/newsroom/daily-wire/asset-exempt-in-chapter-13-retains-the-exemption-after-conversion-first-circuit).

The opinions by Judge Brown and the BAP offer more elaborate explanations for why appreciation would not vest in a chapter 7 estate on conversion from chapter 13. For ABI’s discussion of a recent case where the debtors lost appreciation in a homestead on conversion, [click here](https://www.abi.org/newsroom/daily-wire/chapter-13-debtors-lost-appreciation-in-property-after-conversion-to-%E2%80%987%E2%80%99).

[The opinion is](https://abi-opinions.s3.amazonaws.com/Rodriguez+v+Barrera.pdf) *Rodriguez v. Barrera (In re Barrera)*, 20-1376 (10th Cir. Jan. 19, 2022).

#### Disclosing a lawsuit in the SOFA and discussing the suit with the trustee was no substitute for listing the suit among a debtor’s assets, the Ninth Circuit held.

# Disclosing a Lawsuit Only in the SOFA Won’t Result in Abandonment, Circuit Says

On an issue where the lower courts are split, the Ninth Circuit affirmed the Bankruptcy Appellate Panel by holding that an asset is not automatically abandoned if it was disclosed only in the statement of financial affairs and not on the schedule of assets.

No matter what the practice might have been before adoption of the Bankruptcy Code, disclosure to the trustee does not satisfy the requirements of Section 554(c), according to the October 19 opinion by Circuit Judge Ryan D. Nelson.

Lawsuit Not Scheduled but Listed on the SOFA

A couple had begun a lawsuit against their mortgage servicer before filing in chapter 7. They disclosed the suit in the statement of financial affairs but did not list the claim or its value in the schedule of assets. The couple also discussed the claim with the trustee and gave him copies of the pleadings.

Although not mentioned in Judge Nelson’s opinion, the bankruptcy court docket reveals that the trustee decided not to pursue the lawsuit given the cost of prosecution and the uncertainty of a favorable result.

The trustee issued a no-asset report and certified that he had fully administered the estate. The court discharged the trustee and closed the case.

The debtors continued prosecuting the suit after discharge. With a hearing on summary judgment approaching, the defendant servicer approached the trustee and made a settlement proposal. After the trustee reopened the case, the bankruptcy court approved the settlement. Concluding that the lawsuit had not been abandoned, the bankruptcy court gave the proceeds to the trustee for distribution to creditors.

The debtors appealed and lost in a July 2, 2020, opinion for the Ninth Circuit Bankruptcy Appellate Panel by Bankruptcy Judge Laura S. Taylor. *See* *Stevens v. Whitmore (In re Stevens)*, 617 B.R. 328 (B.A.P. 9th Cir. July 2, 2020). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/disclosing-a-lawsuit-only-in-the-sofa-won%E2%80%99t-result-in-abandonment-bap-says).

The debtors argued in the BAP that the lawsuit had been abandoned automatically under Section 554(c). Although not mentioned by the BAP or the circuit, the bankruptcy court’s docket shows that the defendant offered $50,000 to settle. Judge Nelson said that the debtors were looking for 10 times more if they had maintained control of the lawsuit.

‘Plain Language’ Dictates the Outcome

The outcome in the circuit turned on the interactions between Sections 554(c) and 521(a)(1). The former provides that an asset not administered is “abandoned to the debtor” if it was “scheduled under section 521(a)(1).”

For Judge Nelson, the analysis was largely a linguistic exercise. No circuit court has addressed the issue. The lower courts are split. Some believe that an asset is abandoned only if it was scheduled as an asset under Section 521(a)(1)(B)(i). Others believe that an asset will have been abandoned if it was included in the statement of affairs under Section 521(a)(1)(B)(iii).

Among the circuits, only the Second Circuit mentioned the issue but left the question undecided. *See* *Ashmore v. CGI Grp. Inc.*, 923 F.3d 260 (2d Cir. 2019). To read ABI’s report on *Ashmore*, [click here](https://www.abi.org/newsroom/daily-wire/disclosing-an-asset-in-the-wrong-place-won%E2%80%99t-invoke-judicial-estoppel-circuit).

Judge Nelson said that the dictionary meaning of the word “scheduled” as used in Section 554(c) means “to include something on a literal schedule.” The court, he said, “must give ‘schedule’ and ‘scheduled’ similar meanings: scheduled means included on a schedule.” Listing on the statement of affairs won’t suffice.

Judge Nelson found support in the Bankruptcy Rules, which, he said, “routinely distinguish between the bankruptcy petition itself, bankruptcy schedules, the SOFA, and other documents.”

The debtors urged the Ninth Circuit to follow pre-Code law and the understanding that property was abandoned if the trustee knew about it. Now that Congress has enacted the Bankruptcy Code, Judge Nelson said, “we cannot disregard its plain language.”

Judge Nelson conceded that the omission from the schedules may have been “an inadvertent oversight.” Given the statute’s “plain text, . . . we cannot consider equitable arguments,” he said.

Judge Nelson affirmed, holding that “§ 554(c) requires property to be disclosed on a literal schedule, and thus that, absent Trustee or court action, property disclosed only on a statement (*e.g.*, the Statement of Financial Affairs) cannot be abandoned under § 554(c).”

Judge Nelson did not explain what he meant by “Trustee or court action.” Evidently, a trustee’s analysis of an unscheduled claim does not measure up if we can credit facts not mentioned in the circuit opinion.

Observations

In representing corporate and individual debtors before turning to journalism, this writer would confront circumstances where it was unclear whether something should be scheduled as a debt or asset or disclosed in the statement of financial affairs. In those situations, it was our practice to both schedule and list.

Was it malpractice for the debtors’ lawyer not to schedule the lawsuit against the servicer?

Kudos

The debtors paid the filing fee but could not afford the counsel. Recognizing the importance of the issue, the circuit appointed Kellam M. Conover from Gibson, Dunn & Crutcher LLP in Washington, D.C., as *pro bono* counsel for the debtors. With him on the brief were Mark A. Perry and Suria M. Bahadue. Mr. Conover argued. He had clerked on the Ninth Circuit.

Tara Twomey submitted an *amicus* brief for the debtors on behalf of the National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Stevens.pdf) *Stevens v. Whitmore (In re Stevens)*, 20-60044 (9th Cir. Oct. 19, 2021).

### FDCPA and FCRA

#### The Ninth Circuit equates nonjudicial foreclosure with bankruptcy discharge in terms of the effect on deficiencies following foreclosure.

# Nonjudicial Foreclosure Wipes Out Deficiencies for the FCRA, Ninth Circuit Says

Following nonjudicial foreclosure, a lender’s failure to report a deficiency as having been “abolished” (or discharged) establishes “inaccuracy” and opens the door to the “furnisher’s” liability under the federal Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq*., according to the Ninth Circuit.

Although the deficiency may still survive in some existential sense after nonjudicial foreclosure or discharge in bankruptcy, the Ninth Circuit is saying in its May 16 opinion that a lender is barred from mounting a lawsuit or reporting the debt as outstanding. On the other hand, the Supreme Court held 5/3 in Midland Funding LLC v. Johnson, 137 S. Ct. 1407, 197 L. Ed. 2d 790 (2017), that a debt collector who files a proof of claim that is “obviously” barred by the statute of limitations has not engaged in false, deceptive, misleading, unconscionable, or unfair conduct and thus does not violate the federal Fair Debt Collection Practices Act. To read ABI’s report on *Midland Funding*, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-allows-debt-collectors-to-file-time-barred-proofs-of-claim).

So, is the Ninth Circuit on thin ice? If a lender can file a proof of claim based on a time-barred debt and not violate the FDCPA, why is there an FCRA violation when the lender reports that the debt remains outstanding?

Does the inconsistency between the two opinions result from the courts’ differing views about consumer protection laws, or do the factual distinctions justify the differing outcomes?

The Nonjudicial Foreclosure

An individual bought a home in Arizona in 2007 that crashed in value a few years later. The owner lost the home in a nonjudicial foreclosure in 2013.

The home had two mortgages. The foreclosure sale barely covered the first mortgage.

Several years later, the former owner was unable to obtain a mortgage for purchasing a new home because the lender on the foreclosed second mortgage was reporting that the debt was unpaid, outstanding and in default.

The former owner filed a written dispute with a national credit reporting agency, stating that the debt had been “abolished” by Arizona law. Indeed, Circuit Judge M. Margaret McKeown said in her opinion for the Ninth Circuit that the Arizona Supreme Court had held under the state’s Anti-Deficiency Statute that nonjudicial foreclosure “abolish[es]” a borrower’s personal liability.

The former owner filed a second dispute with the reporting agency after the lender continued to report the deficiency as outstanding. After the second dispute, the lender reported the debt as “charged off,” an inaccuracy in itself.

The former owner then sued the lender under the FCRA for providing inaccurate information. The district court dismissed the suit on motion for summary judgment, believing that the reports were accurate as a matter of law. The owner appealed to the circuit.

The Reports Were Inaccurate, as a Matter of Law

To prove a claim under the FCRA against a so-called furnisher like the second-mortgage lender, Judge McKeown said that a consumer must first make a *prima facie* case demonstrating that the report was inaccurate. Then, the consumer must show that the furnisher did not follow “reasonable procedures” to ensure the “maximum possible accuracy.”

Citing the Arizona Supreme Court’s interpretation of the state’s Anti-Deficiency Statute, Judge McKeown said that the former owner’s liability for a deficiency on the foreclosed second mortgage had been “abolished.” She then held that the former owner “was no longer obligated to repay the debt.”

Therefore, Judge McKeown said, “It was ‘patently incorrect’ for [the lender-furnisher] to report otherwise.”

Of significance in bankruptcy circles, Judge McKeown said that abolishing the debt under the state statute “was no different than” a discharge of a personal liability in bankruptcy under Section 524(a)(1).

For Judge McKeown, the question was not whether the debt had been entirely extinguished, as the district court had ruled. Rather, she said, “no outstanding balance existed, because the statute abolished his personal liability.”

Judge McKeown therefore held that the former owner had “more than satisfied” his burden of showing *prima facie* inaccuracy.

Next, Judge McKeown addressed the question of whether the lender had conducted a reasonable investigation. Providing guidance for the district court on remand, she said that an investigation by a lender “will often be more extensive and more thorough” than an investigation by a reporting agency.

In fact, Judge McKeown said, lenders will “sometimes” be required to “resolve” questions of “legal significance.”

Because there were genuine factual disputes about the lender’s investigation, Judge McKeown reversed and remanded for further proceedings or a trial regarding the sufficiency of the lender’s investigation.

*Taggart* Questions

There is tension between the outcome in *Midland Funding* and the new case from the Ninth Circuit. But there is more.

In *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1809 (2019), the Supreme Court held that there can be no sanctions for civil contempt of the discharge injunction if there was an “objectively reasonable basis for concluding that the creditor’s conduct might be lawful under the discharge order.”

Had the Ninth Circuit applied *Taggart* to the FCRA, the lender surely would have had a solid defense given that the debt under Arizona law continued to exist but was unenforceable.

Judge McKeown did not discuss *Taggart*. Was it error?

This writer submits there was no error. The discharge injunction contains no statutory standards for contempt, so the Supreme Court in *Taggart* applied common law notions of contempt.

Suits under the FCRA do not entail contempt. Rather, the FCRA sets up its own unique thresholds that must be met before imposing liability.

Although *Taggart* and the case in the Ninth Circuit can be reconciled, the same can’t be said for *Midland Funding* and the Ninth Circuit opinion. Moreover, the Supreme Court will sometimes erect nonstatutory barriers to the enforcement of consumer protection laws by invoking federal common law using the doctrine of prudential standing. *See, e.g.*, *Spokeo Inc. v. Robins*, 136 S. Ct. 1540 (2016); and *TransUnion LLC v. Ramirez*, 20-297 (Sup. Ct. June 25, 2021).

To read ABI’s reports on *Spokeo* and *TransUnion*, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-temporarily-ducks-case-on-individuals%E2%80%99-right-to-sue) and [here](https://www.abi.org/newsroom/daily-wire/supreme-court-majority-deals-a-blow-to-enforcement-of-consumer-protection-laws).

This writer submits there is a fundament difference between the Ninth Circuit and the Supreme Court when it comes to consumer protection. We leave it for the reader to decide which court has the better approach.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Gross+9+Cir..pdf) *Gross v. CitiMortgage Inc.*, 20-17160 (9th Cir. May 16, 2022).

#### A statutory violation by itself won’t necessarily give a plaintiff constitutional standing.

# Sixth Circuit Erects Barriers to FDCPA Suits by Consumers in a 2/1 Opinion

Over a dissent, the Sixth Circuit held that a debt collector’s failure to identify itself accurately does not give the creditor constitutional standing to file suit for violation of the federal Fair Debt Collection Practices Act, or FDCPA, 15 U.S.C. § 1692-1692p.

The August 16 opinion is the latest example of courts striving to understand the Supreme Court’s recent rulings about constitutional standing in *Spokeo Inc. v. Robins*, 136 S. Ct. 1540 (2016), and *TransUnion LLC v. Ramirez*, 141 S. Ct. 2190 (2021). To read ABI’s reports, [click here](about:blank) and [here](about:blank).

The trend is not favorable for consumers who file suits based on statutory violations and not much more.

The Simple Facts

The essential facts underpinning the appeal to the Sixth Circuit are few and simple.

A consumer owed a small debt to a hospital. The hospital turned over collection to an outfit that was allegedly a debt collector whose activities would be regulated by the FDCPA.

The debt collector sent a handful of letters to the consumer asking for payment. The letters correctly identified the debt collector. The consumer did not allege that the letters violated the FDCPA.

The debt collector also left several voicemail messages that did not state the debt collector’s full corporate name. The failure to give the full name could have been confusing because there was another company with a similar name.

After receiving three or four voicemail messages, the consumer contacted a lawyer and sent a cease and desist letter to an entity that was not the debt collector who had left the voicemail messages. After the letter, the consumer received one more voicemail message, indicating that the cease and desist letter may not have accomplished its purpose.

A few months later, the consumer sued the alleged debt collector, claiming violations of the FDCPA. After the close of discovery, the defendant filed a motion for summary judgment. The district court granted the motion and dismissed the suit, having decided that the defendant was not a debt collector subject to the FDCPA.

The Majority’s Opinion

The consumer appealed. In an eight-page opinion for the majority, Circuit Judge R. Guy Cole, Jr. vacated the order granting summary judgment and remanded with instructions to dismiss the suit for lack of jurisdiction.

The circuit court raised standing for the first time on appeal because, as Judge Cole said, a court has an independent duty to establish its own jurisdiction, and a plaintiff’s lack of Article III standing is jurisdictional.

Under *Spokeo*, Judge Cole explained that a plaintiff has constitutional standing under Article III if there was an injury in fact that was “fairly traceable” to the defendant’s conduct and that is likely to be redressed by a favorable court ruling.

To establish injury in fact, *Spokeo* decreed that the injury must be “particularized” and “concrete.” The parties agreed that the injury was particularized but disagreed about whether the consumer had suffered a concrete injury.

The consumer contended that his harm was concrete because he was confused about the identity of the caller, consulted a lawyer, sent a cease and desist letter to the wrong entity and then received another call.

On that score, Judge Cole cited *Spokeo* for teaching that a statutory violation is a violation of a procedural right that by itself may not satisfy the requirement of injury in fact. He went on to cite *TransUnion* for the proposition that the mere risk of future harm by itself does not qualify as concrete harm.

Judge Cole therefore said that the consumer was required to show that the procedural violation itself was a concrete injury “of the sort traditionally recognized” or caused an independent concrete injury.

For Judge Cole, the defendant’s failure to identify itself accurately was not close enough to an invasion of privacy to bestow standing.

With regard to independent concrete injury, the consumer claimed he was harmed because he was confused, hired counsel, sent a cease and desist letter to the wrong entity and received another voicemail.

Judge Cole ruled that the consumer could not show concrete harm simply by having hired counsel. If that were enough, he said, hiring “counsel to affirmatively pursue a claim would nullify the limits created under Article III.”

In conclusion, Judge Cole said the consumer had shown nothing more than “a bare procedural violation of the FDCPA” and therefore lacked constitutional standing to mount suit. He reversed and remanded with instructions to dismiss the suit for lack of jurisdiction.

The Dissent

Circuit Judge Karen Nelson Moore “respectfully” dissented. For her, confusion about the debt collector’s proper corporate name and the resulting voicemail message was a “sufficiently concrete” injury to confer standing, constitutionally speaking.

Judge Moore said that misidentification of the debt collector and the subsequent voicemail “resembles a harm recognized under the common-law tort of intrusion upon seclusion.” In her view, the “difference between one unwanted call and many is one of degree, not of kind.” A single unwanted call, she said, “is a concrete harm” conferring standing.

“We may think that Congress has elevated a relatively insignificant harm, but that was Congress’s decision to make, and it is not a reason to hold that [the plaintiff] lacks standing to sue,” Judge Moore said.

“In sum,” Judge Moore said, there was constitutional standing, and therefore jurisdiction, in view of the “single unwanted voicemail.” Although one voicemail “may seem trivial or insignificant, . . . it is concrete and that is all that we are to decide under the Court’s standing precedent.”

Observations

Much like substantive due process violations found by the Supreme Court during the Franklin Roosevelt administration, the lack of Article III jurisdiction flowing from a statutory violation isn’t something Congress can address through legislation.

Lawyers for consumers must hope that federal courts will follow Judge Moore’s dissent and find constitutional standing even for “trivial” injuries.

Even if trivial injury suffices to establish standing, it doesn’t mean that a court or jury would find liability for violating the FDCPA.

This case is an example. Even if the consumer had standing, the district court still dismissed on summary judgment after ruling that the defendant was not a debt collector.

[The opinion is](about:blank) *Ward v. National Patient Account Services Solutions Inc.*, 20-5901. 2021 BL 308015, 2021 Us App Lexis 24369 (6th Cir. Aug. 16, 2021).

### Priority Claims

#### The Affordable Care Act’s ‘individual mandate’ was a tax measured by income, thus giving the IRS a priority tax claim.

# Two Circuits Now Give Priority Status to Obamacare’s Individual Mandate Penalty

Agreeing with a nonprecedential opinion from the Fifth Circuit and the majority on a recent decision from the Sixth Circuit Bankruptcy Appellate Panel, the Third Circuit held that the “penalty” imposed on a taxpayer for failure to purchase health insurance under the Affordable Care Act (a/k/a ACA or Obamacare) is a “tax” afforded priority under Section 507(a)(8).

The Fifth Circuit opinion is *U.S. v. Chesteen (In re Chesteen)*, 799 F. App’x 236, 241 (5th Cir. Feb. 20, 2020). To read ABI’s report, [click here](https://www.abi.org/newsroom/daily-wire/fifth-circuit-rules-that-the-penalty-under-the-aca-isn%E2%80%99t-a-priority-tax-claim). The BAP opinion from the Sixth Circuit is *In re Juntoff*, 636 B.R. 868 (B.A.P. 6th Cir. Mar. 21, 2022). [Click here](https://www.abi.org/newsroom/daily-wire/sixth-circuit-bap-gives-priority-status-to-obamacare%E2%80%99s-individual-mandate) to read ABI’s report on *Juntoff*.

At least for the time being, the decisions on the ACA lack broad significance because Congress lowered the “penalty” to zero after the taxes were assessed in the cases that went up on appeal. However, the courts’ analyses will provide guidance for legislators in the future if they adopt a new form of health care built on the ACA and invoke another individual mandate intended to be (or intended not to be) a priority tax.

Typical Facts

In 2018, the debtor did not purchase health insurance under the so-called individual mandate, which the ACA referred to as a “penalty” and a “shared responsibility payment.” The debtor filed a chapter 13 petition in 2019.

The Internal Revenue Service filed a $927 priority proof of claim for unpaid taxes resulting from the failure to purchase health insurance in 2018. The debtor objected to the claim, contending that the exaction was not a tax and was not entitled to priority.

The bankruptcy court ruled that the exaction was a tax, not a penalty, and was entitled to priority.

The district court upheld the judgment by holding that the exaction was a tax on income entitled to priority. The debtor appealed to the circuit.

In his May 11 opinion, Circuit Judge Thomas M. Hardiman said that his panel was tasked with deciding whether the exaction was a tax for bankruptcy purposes and, if it was, whether the tax was entitled to priority.

Governing Law

In *National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012), the Supreme Court held that the shared responsibility payment was a tax for constitutional purposes but was not a tax for the Anti-Injunction Act. However, Judge Hardiman said that the ACA “exaction could function as a tax for the broader purpose of constitutional validity, but not within the narrower confines of bankruptcy priority.”

“Accordingly,” Judge Hardiman said, “there is no reason to conclude that *Sebelius*’s constitutional analysis is controlling in the context of the Bankruptcy Code.”

Following other Supreme Court authority in characterizing an exaction as a “tax,” Judge Hardiman said that the Third Circuit conducts a “functional analysis.” Of special significance, he said, is whether the exaction confers any benefit on the taxpayer not enjoyed by everyone else.

Under the Third Circuit’s governing analysis adopted in 2005 from a 1982 Ninth Circuit opinion, Judge Hardiman said that the exaction was not exchanged for a benefit not shared by others. Furthermore, he said, it was calculated and administered like a tax. In addition, the exaction “lacks typical penal characteristics.”

Judge Hardiman therefore held that the exaction “is a tax for bankruptcy purposes.”

Priority Status?

Next, Judge Hardiman confronted the question of whether the tax was entitled to priority under Section 507(a)(8) as either “a tax on or measured by income” or “an excise tax on . . . a transaction.”

Judge Hardiman conceded that the payment was not a traditional tax on income. Still, he said, the plain language of the statute gives priority not only to income taxes but also to taxes “whose amounts are calculated based on the taxpayer’s income.”

The debtor’s income “played an essential role” in deciding the amount of the tax, Judge Hardiman said. He therefore held that the exaction was entitled to priority as a tax “measured by income,” even though the relevant provision in the IRS Code was titled “Miscellaneous Excise Taxes.”

Judge Hardiman said that titles within the IRS Code “have no legal effect.”

If the exaction were found to be an excise tax, Judge Hardiman said in a footnote that it would not be entitled to priority because the failure to purchase health insurance was not a “transaction.”

[The opinion is](https://abi-opinions.s3.amazonaws.com/SZCZYPORSKI.pdf) *In re* *Szczyporski*, 21-1858 (3d Cir. May 11, 2022).

##### Cross-Border Insolvency

#### Judge Vaughan explains why a foreign debtor isn’t required to have a presence in the U.S. before the debtor’s foreign representatives can win recognition under chapter 15.

# Eleventh Circuit Predicted to Split with the Second Circuit on Foreign Recognition

Bankruptcy Judge Lori V. Vaughan of Orlando, Fla., predicts that the Eleventh Circuit will split with the Second Circuit and hold that a bankruptcy court may grant foreign main recognition under chapter 15 even if the debtor has no residence, domicile, place of business or property in the U.S.

Judge Vaughan was referring to a Second Circuit decision, *In re Barnet*, 737 F.3d 238 (2d Cir. 2013), where Australian liquidators of a corporation were seeking foreign main recognition under Section 1517. The bankruptcy court granted recognition even though the debtor had no residence, domicile, place of business or property in the U.S., a seeming requirement under Section 109(a).

On direct appeal, the Second Circuit reversed, based on the plain language of Section 103, which makes Section 109 applicable in chapter 15 cases.

Believing that *Barnet* was wrongly decided, Prof. Jay L. Westbrook told ABI that Judge Vaughan wrote an “excellent opinion, reflecting the fact that chapter 15 is fundamentally different in focus and procedure and its unique definition of ‘debtor’ should obviously prevail over the general one.”

Prof. Westbrook is the country’s leading authority on cross-border insolvency and occupies the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law. He was an author of a scholarly article debunking *Barnet* line by line. *See* Glosband and Westbrook, “Chapter 15 Recognition in the U.S.: Is a Debtor ‘Presence’ Required?,” *Int. Insolv. Rev.*, Vol. 24: 28–56 (2015).

The Individual Debtor in Judge Vaughan’s Case

The debtor was an individual in the case before Judge Vaughan. He had been adjudicated bankrupt in the High Court of Justice of England and Wales. The joint liquidators filed a chapter 15 petition and sought recognition of the proceedings in the U.K. as the foreign main proceeding.

The standards for recognition are contained in Section 1517(a), which provides that the court “shall” grant recognition if:

(1) such foreign proceeding for which recognition is sought is a foreign main proceeding or foreign nonmain proceeding within the meaning of section 1502;

(2) the foreign representative applying for recognition is a person or body; and

(3) the petition meets the requirements of section 1515.

The debtor conceded that the liquidators satisfied all three requirements for recognition under Section 1517. Still, the debtor argued that the court should not grant recognition because he did not fit the description of a debtor in Section 109. That section says:

[O]nly a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title.

The debtor claimed that he did not have a residence or domicile in the U.S. and no longer had any business or property in the U.S. Relying on *Barnet*, the debtor called on Judge Vaughan to deny recognition.

Judge Vaughan declined the invitation. For a host of reasons, she concluded that “the Eleventh Circuit would likely disagree with the *Barnet* holding.”

Section 109(a) Yields to More Specific Provisions

Judge Vaughan’s August 31 opinion leaves the reader with the impression that Section 109(a) was thoughtlessly drafted and inconsistent with other, more specific provisions in chapter 15 regarding recognition.

Because the facts met all three requirements of Section 1517(a), Judge Vaughan said that the “plain language” of the section “requires this Court to recognize the U.K. bankruptcy.”

“For the purposes of this chapter [15],” Section 1502(1) defines a “debtor” to mean “an entity that is the subject of a foreign proceeding.” Judge Vaughan therefore concluded that Section 109(a) does not apply in chapter 15 cases. Were it otherwise, Section 1502(1) would have no meaning.

Judge Vaughan also took guidance from 28 U.S.C. § 1410(3), which places venue of chapter 15 cases where there is a lawsuit against a debtor who has no business or assets in the U.S.

Judge Vaughan alluded to subsections (b) through (g) of Section 109, which specifies who may be debtors under chapters 7, 9, 11, 12 and 13. Chapter 15 is “[n]otably absent,” she said.

Section 109(h) requires individuals to have taken a course in credit counseling. Because a foreign debtor would always have been declared bankrupt in another country, Judge Vaughan said that the “plain language” of Section 109(h) “would always require a waiver by the Court or an exception to apply.”

“[A]s a whole,” Judge Vaughan held that “the plain language” of Section 109 “demonstrates it should not apply to recognition of foreign debtors under chapter 15.”

*Barnet* Won’t Be Followed

To conclude her opinion, Judge Vaughan considered whether the Eleventh Circuit would follow *Barnet*. She cited *In re Goerg*, 844 F.2d 1562 (11th Cir. 1988), where the Eleventh Circuit held under former Section 304 that a foreign representative could conduct ancillary proceedings regarding a foreign debtor that did not qualify as a debtor under Section 109. Section 304 was the predecessor to chapter 15.

Because Section 109 was on the books when *Goerg* was written, Judge Vaughan concluded that the Eleventh Circuit would continue to follow *Goerg* and would reject *Barnet*.

Even if *Barnet* were the standard, Judge Vaughan held that the debtor met the requirements of Section 109(a), because he was an indirect owner of corporations that owned property in the district. Further, the foreign representatives held claims that would qualify as property in the U.S.

Judge Vaughan granted recognition as a foreign main proceeding.

Observation

The ink was barely dry on *Barnet* before it was emasculated by the bankruptcy courts. Even though she was reversed in *Barnet*, the bankruptcy judge granted recognition on remand, finding that the retainer given to U.S. counsel for the foreign representatives and claims in the U.S. satisfied Section 109(a). *In re Octaviar Administration Pty Ltd*, 511 B.R. 361 (Bankr. S.D.N.Y. June 19, 2014). Other courts have used the same rationale to grant recognition.

The article by Prof. Westbrook and Mr. Glosband, *supra*, picks apart every flaw in *Barnet*. Fundamentally, they explain why the Second Circuit “confuse[d] the foreign debtor with the foreign insolvency representative.” *Id*. at 28. In detail, they explain why the Second Circuit “either reject[ed] or ignore[d] the meaning, plain or otherwise, of other sections of title 11 that establish that the debtor subject to the foreign proceeding is not a debtor under title 11 and that the foreign proceeding, not the debtor, must be eligible for recognition.” *Id.* at 44.

The two commentators say that Section 109(a) does apply in chapter 15 cases, but they explain the limited circumstances where it governs. For instance, the foreign debtor must have a presence in the U.S. when foreign representatives use their power under Section 1511 to file a “full” case under Sections 301, 302 or 303. Section 109(a) also applies when a foreign debtor files a bankruptcy case in the U.S. to enforce a foreign discharge.

“Conversely,” Prof. Westbrook and Mr. Glosband said, “the reason that section 109(a) does not apply to recognition is that the debtor in the foreign proceeding will not, by virtue of chapter 15 recognition of the foreign proceeding, become ‘a debtor under this title.’”

The two commentators faulted the Second Circuit for failing to “explain why the plain meaning of section 109(a) trumps the plain meaning of section 1502.” “For the purposes of this chapter,” Section 1502(1) says that the term “‘debtor’ means the entity that is the subject of a foreign proceeding.”

Prof. Westbrook and Mr. Glosband meticulously explain why “section 1502(1) supplants section 101(13) within and without Chapter 15; the phraseology ‘for purposes of’ does not permit the application of dual definitions.”

Whenever a court or counsel faces a question similar to the issue confronting Judge Vaughan, we recommend extensive reliance on the article by Prof. Westbrook and Mr. Glosband.

[The opinion is](about:blank) *Al Zawani*, 21-10251, 2021 BL 329515, 2021 Bankr Lexis 2367 (Bankr. M.D. Fla. Aug. 31, 2021).

#### Citing Ritzen as the reason, the Eleventh Circuit disagreed with the Second Circuit regarding the finality of Rule 2004 discovery orders in chapter 15 cases.

# Circuits Split on Finality of Rule 2004 Discovery Orders in Chapter 15 Cases

In a nonprecedential opinion, the Eleventh Circuit split with the Second Circuit by holding that a discovery order in a chapter 15 case under Bankruptcy Rule 2004 is nonfinal and thus not appealable, even if the discovery was not sought in a pending adversary proceeding or contested matter.

The Atlanta-based appeals court appears to have ruled that a discovery order is not final and therefore not appealable if the fruits of discovery could be used in an adversary proceeding or contested matter that might be brought later.

Discovery by the Foreign Representative

The foreign representative of a Brazilian airline had received recognition of the Brazilian liquidation as a foreign main proceeding under chapter 15. According to the July 19 opinion by Circuit Judge Beverly B. Martin, the chapter 15 case was designed to locate assets of the debtor that were in the U.S. or transferred through the U.S.

In Brazil, the Brazilian trustee was in litigation attempting to pierce the corporate veil as to certain nondebtor third parties. The Brazilian trustee was aiming to include the third parties’ assets in the bankrupt estate.

Not having yet pierced the corporate veil, the Brazilian court had frozen the third parties’ assets and indicated in an order that the freeze should be implemented in the U.S. chapter 15 case.

The Brazilian trustee, as the foreign representative, obtained subpoenas from the bankruptcy court in Miami under Bankruptcy Rule 2004, directing several financial institutions to produce documents about the third parties’ banking and financial information.

The bankruptcy court denied the third parties’ motion for a protective order. The third parties appealed, but the district court dismissed the appeal for lack of appellate jurisdiction. The district court reasoned that the discovery order was nonfinal and thus not appealable. The third parties appealed once again to the circuit.

*Ritzen* Governs

Judge Martin began from the “general proposition” that discovery orders are nonfinal. However, the primary authority on finality in the bankruptcy context is *Ritzen Group Inc. v. Jackson Masonry LLC*, 140 S. Ct. 582, 205 L. Ed. 2d 419 (Sup. Ct. Jan. 14, 2020), where the Supreme Court held that an order denying a motion to modify the automatic stay is a final order that may be appealed. To read ABI’s report on *Ritzen*, [click here](https://www.abi.org/newsroom/daily-wire/supreme-court-rules-that-%E2%80%98unreservedly%E2%80%99-denying-a-lift-stay-motion-is-appealable).

More specifically, Judge Martin quoted the Supreme Court for holding that orders in a bankruptcy case “qualify as ‘final’ when they definitively dispose of discrete disputes within the overarching bankruptcy case.” *Id.*, 140 S. Ct. at 586.

To decide whether an order is final and appealable, the Supreme Court went on to command that the appellate court must identify “the appropriate procedural unit for determining finality.” *Id*., 140 S. Ct. at 588-589.   
  
In the case on appeal, Judge Martin said that the procedural unit was the implementation of the freeze order in the chapter 15 case. She arrived at this conclusion because “the record is clear” that the foreign representative was seeking discovery to aid in implementation of the Brazilian freeze order.

The Split with the Second Circuit

The third parties relied on Second Circuit authority that was almost, if not exactly, on point, despite Judge Martin’s statements to the contrary. *Drawbridge Special Opportunities Fund LP v. Katherine Elizabeth Barnet* (*In re Barnet)*, 737 F.3d 238 (2d Cir. 2013).

In *Barnet*, a foreign representative was seeking foreign main recognition and sought discovery from a company. The court denied the company’s motion to stay discovery. On appeal, Judge Martin said that the Second Circuit “categorically” held that a discovery order in a chapter 15 case is immediately appealable.

Primarily, the Second Circuit analogized the chapter 15 case to discovery in aid of a foreign proceeding under 28 U.S.C. § 1782(a), where discovery orders are immediately appealable. In Section 1782 matters, a discovery order would be the final resolution of the dispute.

The Second Circuit reasoned that chapter 15 cases, like petitions under Section 1782, are ancillary to a suit in another tribunal, “such that there will never be a final resolution on the merits beyond the discovery relief itself.” *Id*. at 244.

Judge Martin said that *Barnet* was “distinguishable,” because it was decided before *Ritzen*. Therefore, she said, the Second Circuit “did not wrestle with the question of whether discovery under Chapter 15 is a ‘discrete’ or ‘separate’ proceeding or ‘merely a preliminary step’ in some other proceeding.” *Ritzen*, *supra*, 140 S. Ct. at 589–90.

Judge Martin also rejected the Second Circuit’s analogy between chapter 15 and Section 1782. In Section 1782, she said, “there is nothing but discovery.” In chapter 15, by contrast, she said that “a discovery order is ordinarily a ‘preliminary step’ of a larger proceeding.”

In the case on appeal, Judge Martin said that the discovery order was only a preliminary step in a forthcoming freeze proceeding in bankruptcy court.

Judge Martin rejected arguments that the discovery order fell within exceptions to the final order doctrine. She dismissed the appeal for lack of appellate jurisdiction.

Observations

According to a brief filed by third parties in the circuit, the foreign representative had not brought any proceedings in the bankruptcy court to extend the freeze order to the U.S. through the chapter 15 case.

This writer therefore interprets the Eleventh Circuit’s opinion to mean that the mere possibility of a later contested matter or adversary proceeding is sufficient to render a discovery order under Bankruptcy Rule 2004 beyond the pale of appeal, assuming the court does not grant leave to take an interlocutory appeal.

This writer questions whether *Ritzen* entirely altered the analysis regarding appeals of discovery orders in chapter 15 cases, where there may or may not be proceedings aside from discovery.

Considerations such as these may explain why the Eleventh Circuit’s opinion is nonprecedential.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Fontana.pdf) *Estate of Omar Fontana v. ACFB Administracao Judicial Ltda (In re Transbrasil S.A. Linhas Aereas)*, 20-12238 (11th Cir. July 19, 2021).

#### The bankruptcy court has no discretion to deny recognition in chapter 15 if the requirements of Section 1517(a) have been met.

# Bad Faith Filings in Chapter 15 Entitled to ‘Foreign Main Recognition,’ BAP Says

A bad faith filing is no basis for denying recognition of a foreign main proceeding under chapter 15 “if all three requirements of § 1517(a) are met,” the Ninth Circuit Bankruptcy Appellate Panel recently held.

A foreign representative is entitled to recognition even if the filing was not a legitimate use of chapter 15, Bankruptcy Judge Julia W. Brand said in her February 17 opinion for the BAP.

Before concluding that the BAP lost its mind by condoning bad faith, be sure to read the end of this report, where Judge Brand lays out the relief available to a creditor who can show that chapter 15 is being misused.

The Bankruptcy in Monaco

Incorporated in Monaco, the debtor was the sole distributor in Europe for a California-based producer of lubricants. The California creditor held 96% of the debt owing by the debtor.

The creditor alleged that the debtor had misappropriated its trade secrets and customer lists to establish a competing business. The creditor initiated an arbitration in California where the arbitrator awarded the creditor almost $1.1 million. The federal court in California confirmed the arbitration award.

Believing that the debtor’s owner had fraudulently transferred the debtor’s assets, the creditor was undertaking discovery in California aimed at identifying assets or transfers of assets.

The debtor filed an insolvency proceeding in Monaco followed by a chapter 15 petition in Oakland, Calif. The chapter 15 filing imposed an automatic stay on discovery.

The Monegasque trustee sought recognition of the proceedings in Monaco as a foreign main proceeding under Section 1517(b)(1). The creditor opposed.

The creditor argued in bankruptcy court that the Monegasque bankruptcy and the chapter 15 cases were shams to protect the debtor’s owner and shield fraudulently transferred assets.

Among other things, the bankruptcy court found that the owner was paying the Monegasque trustee’s attorneys’ fees and that the trustee’s lawyers had also represented the debtor in California district court. According to Judge Brand, the bankruptcy judge found that the trustee was not a “true fiduciary” and that the facts “cast doubt on the integrity of the proceeding and [the debtor’s] good faith.”

The bankruptcy court denied recognition, concluding that the case was not a legitimate use of chapter 15 for the purposes intended by Section 1501. According to Judge Brand, the bankruptcy court “believed that the real purpose of the filing was to preclude [the creditor] from recovering on its Judgment and to protect [the owner and another business he owned] from their own wrongful conduct.”

“Because the [bankruptcy] court found the filing to be improper under § 1501, it made no findings under § 1517,” Judge Brand said. The debtor appealed to the BAP, which reversed.

The Standards for Recognition

Judge Brand devoted several pages to laying out the nuts and bolts of reorganization and liquidation proceedings in Monaco. Although insolvencies in Monaco do not mimic U.S. bankruptcies precisely, the Monegasque law struck this writer as similar to the laws of other countries entitled to recognition under chapter 15.

Judge Brand laid out the two most relevant statutes, Sections 1501 and 1517(a).

Section 1501 contains the statement of purpose for chapter 15, including cooperation between courts in the U.S. and those abroad with the provision of “effective mechanisms for dealing with cases of cross-border insolvency.”

Section 1517(a) demands that recognition “shall” be granted if (1) the foreign proceeding is main or non-main, (2) the foreign representative is a person or body and (3) the petition meets the requirements of Section 1515.

In bankruptcy court, there had been no dispute about the satisfaction of the three requirements.

Reversal was foretold early in her opinion when Judge Brand said she “could not locate . . . another case where a court has applied § 1501 to determine recognition of a foreign proceeding.” She said that the bankruptcy court “impermissibly engaged in a more discretionary analysis than what recognition under § 1517 authorizes.”

Judge Brand said that “Section 1501 does not control recognition of a foreign proceeding. Rather, recognition is governed by §§ 1515 through 1524.”

However, there is a safety valve in Section 1506, Judge Brand said. It says,

Nothing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.

In other words, “recognition is mandatory if all three requirements of § 1517(a) are met and there is no public policy basis to deny it,” Judge Brand said.

Given that the requirements of Section 1517(a) were satisfied, Judge Brand examined whether recognition would be “manifestly contrary” to U.S. public policy.

With the facts not in dispute, Judge Brand found nothing “manifestly contrary” to U.S. public policy. She analyzed several other chapter 15 cases where “a party’s misconduct or bad faith [was] not a proper basis for invoking § 1506 to deny recognition.” She cited a case with “more egregious” facts where recognition had been granted.

Judge Brand reversed and ruled that the proceedings in Monaco were entitled to foreign main recognition.

The Safety Valve

Although the foreign proceeding was entitled to recognition, Judge Brand said the court is not “helpless when faced with misconduct or bad faith in a chapter 15 case.” After recognition, she said that the court “has a considerable amount of discretion.”

If there is misconduct or bad faith, Judge Brand said that the court’s tools include relief from the automatic stay, abstention or dismissal.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Black+Gold.pdf) *Samba v. International Petroleum Products & Additives Co. (In re Black Gold SARL)*, 21-168 (B.A.P. 9th Cir. Feb. 17, 2022).

#### Judge Garrity wasn’t required to rule on whether Bankruptcy Rule 2004 applies in chapter 15 cases.

# Chapter 15 Permits Discovery to Lay Groundwork for a Lawsuit, New York Judge Says

Bankruptcy Judge James L. Garrity, Jr., authorized the foreign representative of a South African airline to take discovery from Boeing under Section 1521(a)(4) regarding claims and defenses related to a purchase agreement for eight 737 MAX 8 aircraft.

The airline had 27 aircraft and 2,000 employees. In 2013, the airline contracted to buy the eight aircraft from Boeing.

The airline’s finances were deteriorating even before the pandemic. Eventually, the airline was forced to ground all aircraft.

Under the aegis of joint business rescue practitioners, or BRPs, the airline commenced business rescue proceedings in South Africa in May 2020 under Chapter 6 of the South African Companies Act of 2008. Later, the BRPs obtained approval of a business rescue plan.

Before the airline’s insolvency proceedings, the airline had paid for and Boeing had delivered the first of the eight new aircraft. The new aircraft was delivered just before the second crash of a 737 MAX 8, which resulted in the grounding of the MAX 8 fleet worldwide. The airline had also made pre-delivery payments for additional aircraft.

Before the insolvency proceedings, the airline had purported to cancel the purchase agreement for all eight aircraft. The BRPs confirmed the airline’s cancellation. The rescue plan also authorized the cancellation of the purchase agreement.

The BRPs commenced a chapter 15 case in New York in February 2021. The bankruptcy court granted foreign main recognition and recognized the BRPs as foreign representatives. The recognition order authorized the foreign representatives to exercise the powers of a trustee provided by Sections 1520 and 1521.

In March 2021, the foreign representatives sent a letter to Boeing outlining claims for breach of contract and fraudulent inducement. Boeing responded by confirming that the purchase agreement was terminated but otherwise reserved its rights against the airline.

In August 2021, the foreign representative filed a motion in bankruptcy court under Section 1521 and Bankruptcy Rule 2004 to take discovery from Boeing. The aircraft manufacturer objected on a variety of grounds, but Judge Garrity granted the motion in an opinion on November 14.

Judge Garrity explained how Section 1521(a) contains a non-exclusive list of relief available to a foreign representative. “[T]o effectuate the purpose of this chapter and to protect the assets of the debtor,” the section provides that “the court may, at the request of the foreign representative, grant any appropriate relief, including . . . (4) providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor’s assets . . . or liabilities.”

Section 1522(a) provides that the court may grant relief under Section 1521 “only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected.”

Bankruptcy Rule 2004 provides that the court may allow an examination, but it “may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate.”

The grant of chapter 15 recognition did not “bar the requested relief,” Judge Garrity said, because the foreign representatives have a statutory duty under South African law to investigate the company’s affairs. He therefore ruled that “the requested discovery is necessary to facilitate his efforts to assess the viability, strength, and magnitude of potential causes of action against Boeing and the likelihood and extent of a monetary recovery.”

Section 1521, Judge Garrity said, authorizes discovery “without any limitation based on how the foreign representative intends to use the fruits of the requested discovery.” He therefore found that the requested discovery would “effectuate the purpose” of chapter 15.

The aircraft manufacturer contended there was no need to protect the airline’s assets because it was preserving the evidence that the foreign representatives might seek to discover when there is a lawsuit. Boeing also argued that the foreign insolvency proceeding was “essentially complete” because the plan had been approved.

Judge Garrity said there had been no “Termination Events” under South African law. “Accordingly,” he said, “the Rescue Plan and South African law do not foreclose the Foreign Representative from pursuing claims against Boeing in furtherance of his effort to rescue the company.”

“Moreover,” Judge Garrity said, “the fact that the Debtor can seek discovery under the applicable rules of civil procedure if it ultimately commences litigation against Boeing . . . is not a bar to the relief sought in the Motion.” [Reference omitted.] Ruling otherwise, he said, “would completely eviscerate the investigatory function that section 1521(a)(4) is designed to serve.”

Judge Garrity therefore concluded that discovery was “necessary to protect [the airline’s] assets.” He said that the foreign representatives were pursuing discovery to satisfy their duties under South African law and had “established grounds under section 1521(a)(4) to conduct discovery of Boeing relating to causes of action that [the airline] may hold against Boeing and the extent of [the airline’s] potential monetary recovery from Boeing.”

Last, Judge Garrity held that Boeing’s interests were “sufficiently protected,” although Boeing argued that the foreign representatives’ 40 document requests were “massively overbroad.”

With regard to Boeing’s contention that the document requests were overbroad, Judge Garrity directed the parties to meet and confer. In the absence of agreement, he called on them to arrange a discovery conference under the district’s local rules.

Boeing argued that Rule 2004 does not apply in chapter 15 cases. Judge Garrity said the issue was “academic” because the foreign representatives were entitled to discovery under Section 1521(a)(4).

Judge Garrity granted the motion allowing the foreign representatives to conduct discovery.

[The opinion is](https://abi-opinions.s3.amazonaws.com/Comair.pdf) *In re Comair Ltd*., 21-10298 (Bankr. S.D.N.Y. Nov. 14, 2021).