AMERICAN BANKRUPTCY INSTITUTE

2021 Virtual Annual Spring Meeting

Circuit and District Court Splits on Important Bankruptcy Issues with Bill Rochelle

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American Bankruptcy Institute; Santa Fe, N.M.

Hon. Christopher S. Sontchi
U.S. Bankruptcy Court (D. Del.); Wilmington

2021

Proposed Agenda
ASM 'Splits' Panel
April 20, 2021

1. Is the 14 days for a notice of appeal jurisdictional? Materials page 94.

2. Must the debtor be currently involved in business to qualify for subchapter V? Materials pages 183 and 185.

3. After a repeat filing, does the automatic stay automatically terminate as to estate property? Materials pages 36 and 314.

4. May a debtor take credit counseling on the day of filing but after the filing occurs? Materials page 244.

5. Does *Taggart* apply also to automatic stay violations? Materials page 318.

6. Is a 13 trustee paid if the case is dismissed before confirmation? Materials pages 291 and 293.

7. Does an exemption, valid on the filing in 13, remain valid after conversion 7 if it would not be exempt at the time of conversion? Materials pages 296 and 306.

8. Are makewholes allowed in chapter 11? Materials page 125.

Splits Panel – April 2021
Case Citations for Chat Box
3:00 p.m. Eastern Time

1. Is the 14 days for a notice of appeal jurisdictional? *Tennial v. REI Nation LLC (In re Tennial)*, 978 F.3d 1022 (6th Cir. Oct. 28, 2020); Materials page 94.

2. Must the debtor be currently involved in business to qualify for subchapter V? *In re Johnson*, 19-42063, 2021 BL 71942 (Bankr. N.D. Tex. March 1, 2021), and *In re Wright*, 20-01035, 2020 BL 172550, 2020 Bankr Lexis 1240, 2020 WL 2193240 (Bankr. D.S.C. April 27, 2020). Materials pages 183 and 185.

3. After a repeat filing, does the automatic stay automatically terminate as to estate property? *Rose v. Select Portfolio Servicing Inc.,* 19-1035 (Sup. Ct.), *cert den.* June 29, 2020; and *In re Thu Thi Dao*, 616 B.R. 103 (Bankr. E.D. Cal. May 11, 2020). Materials pages 36 and 314.

4. May a debtor take credit counseling on the day of filing but after the filing occurs? *In re Kuykendall*, 20-14818, 2020 BL 377524, 2020 Bankr Lexis 2684, 2020 WL 5823268 (Bankr. D. Colo. Sept. 30, 2020). Materials page 244.

5. Does *Taggart* apply also to automatic stay violations? *Suh v. Anderson (In re Jeong)*, 19-1244, 2020 BL 102971, 2020 Bankr Lexis 714, 2020 WL 1277575 (B.A.P. 9th Cir. March 16, 2020). Materials page 318.

6. Is a 13 trustee paid if the case is dismissed before confirmation? *In re Soussis*, 624 B.R. 559 (Bankr. E.D.N.Y. Nov. 12, 2020); and *In re Evans*, 615 B.R. 290 (Bankr. D. Idaho Feb. 13, 2020). Materials pages 291 and 293.

7. Does an exemption, valid on filing in 13, remain valid after conversion to 7 if it would not be exempt at the time of conversion? *Klein v. Anderson (In re Anderson)*, 20-60014, 2021 BL 70578, 2021 Us App Lexis 5899 (9th Cir. March 1, 2021); and *Hull v. Rockwell (In re Rockwell)*, 968 F.3d 12 (1st Cir. July 30, 2020). Materials pages 296 and 306.

8. Are makewholes allowed in chapter 11? *In re Ultra Petroleum Corp.*, 624 B.R. 178 (Bankr. S.D. Tex. Oct, 26, 2020). Materials page 125.

Polling Questions
Splits Panel – April 20, 2021

1. The 14 day deadline for a notice of appeal is not jurisdictional. Agree or Disagree.

2. The debtor must be currently involved in business to qualify for subchapter V. Agree or Disagree.

3. After a repeat filing, the automatic stay terminates automatically as to estate property. Agree or Disagree.

4. A debtor may take credit counseling on the day of filing but after the filing occurs. Agree or Disagree.

5. The *Taggart* standard for contempt also apply also to automatic stay violations. Agree or Disagree.

6. A13 trustee is paid if the case is dismissed before confirmation. Agree or Disagree.

7. An exemption, valid on filing in 13, remain valid after conversion to 7 if it would not be exempt at the time of conversion. Agree or Disagree.

8. Makewholes are not unaccrued interest and are allowed claims in chapter 11. Agree or Disagree.

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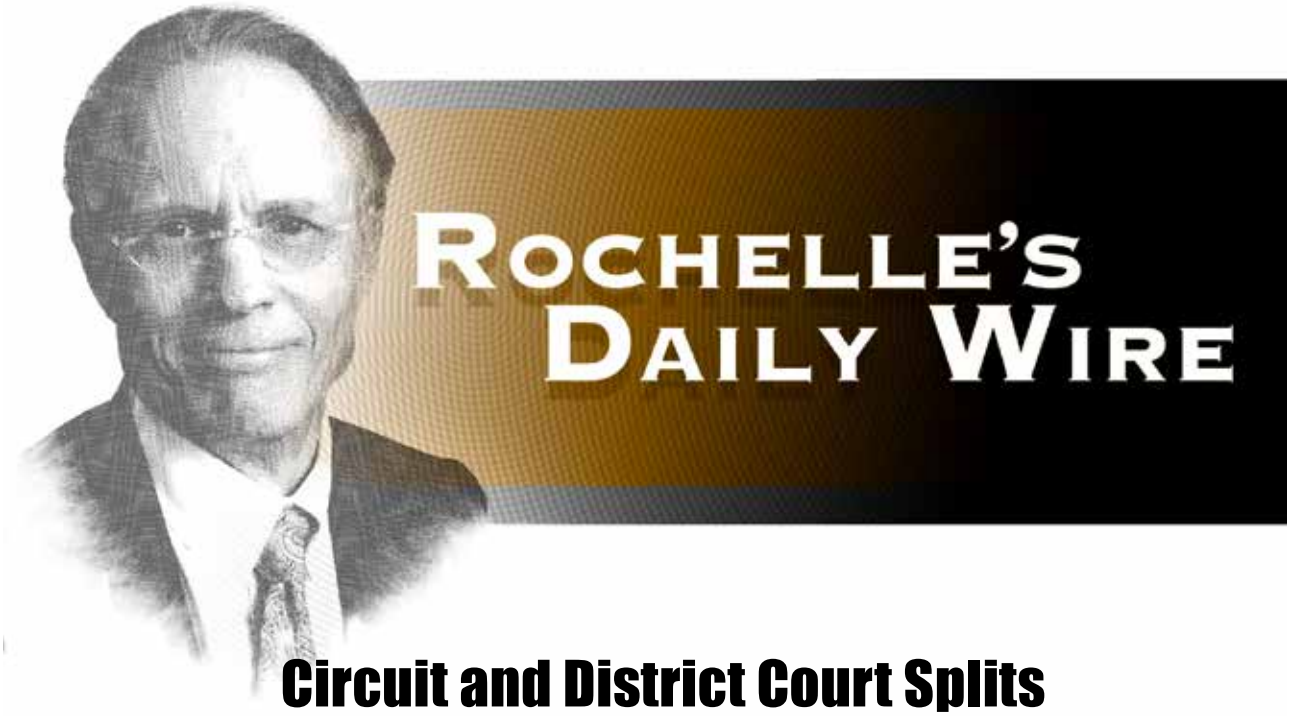

Circuit and District Court Splits on Important Bankruptcy Issues

ABI Annual Spring Meeting
April 20, 2021, 3:00 P.M.

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Supreme Court

Decided This Term

Justices rule that affirmative action is required before withholding property amounts to controlling estate property and results in an automatic stay violation.

Supreme Court Holds that Merely Holding Property Isn't a Stay Violation

Reversing the Seventh Circuit and resolving a split among the circuits, the Supreme Court ruled unanimously today "that mere retention of property does not violate the [automatic stay in] § 362(a)(3)."

Writing for the 8/0 Court in a seven-page opinion, Justice Samuel A. Alito, Jr. said that Section 362(a)(3) "prohibits affirmative acts that would disturb the *status quo* of estate property." He left the door open for a debtor to obtain somewhat similar relief under the turnover provisions of Section 542, although not so quickly.

In a concurring opinion, Justice Sonia Sotomayor wrote separately to explain how a debtor may obtain the same or similar relief under other provisions of the Bankruptcy Code.

Justice Amy Coney Barrett, who had not been appointed when argument was held on October 13, did not take part in the consideration and decision of the case.

The Chicago Parking Ticket Cases

Four cases went to the Seventh Circuit together. The chapter 13 debtors owed between $4,000 and $20,000 in unpaid parking fines. Before bankruptcy, the city had impounded their cars. Absent bankruptcy, the city will not release impounded cars unless fines are paid.

After filing their chapter 13 petitions, the debtors demanded the return of their autos. The city refused to release the cars unless the fines and other charges were paid in full.

The debtors mounted contempt proceedings in which four different bankruptcy judges held that the city was violating the automatic stay by refusing to return the autos. After being held in contempt, the city returned the cars but appealed.

The Seventh Circuit upheld the bankruptcy courts, holding "that the City violated the automatic stay . . . by retaining possession . . . after [the debtors] declared bankruptcy." The city, the appeals court said, "was not passively abiding by the bankruptcy rules but actively resisting Section 542(a)

to exercise control over the debtors' vehicles." *In re Fulton*, 926 F.3d 916 (7th Cir. June 19, 2019). To read ABI's report on the *Fulton* decision in the circuit court, click here.

The Circuit Split

The Second, Seventh, Eighth, Ninth and Eleventh Circuits impose an affirmative duty on creditors to turn over repossessed property after a bankruptcy filing.

The Third, Tenth and District of Columbia Circuits held that the retention of property only maintains the *status quo*. For those circuits, a stay violation requires an affirmative action. Simply holding property is not an affirmative act, in their view.

The City of Chicago filed a *certiorari* petition in September 2019. To resolve the circuit split, the Supreme Court granted *certiorari* in December 2019. Argument was originally scheduled to be held in April 2020 but was postponed until October as a result of the coronavirus pandemic.

The Statute Demanded the Result

Justice Alito laid out the pertinent statutes. Primarily, Section 362(a)(3) stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." In the lower courts, the debtors relied on that section, but not exclusively.

With some exceptions, Section 542(a) provides that "an entity . . . in possession . . . of property that the trustee may use, sell, or lease under section 363 of this title . . . , shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate."

Justice Alito said that the case turned on the "prohibition [in Section 362(a)(3)] against exercising control over estate property." He said the language "suggests that merely retaining possession of estate property does not violate the automatic stay."

To Justice Alito, "the most natural reading" of the words "stay," "act" and "exercise control" mean that Section 362(a)(3) "prohibits affirmative acts that would disturb the status quo of estate property as of the time when the bankruptcy petition was filed." He found a "suggestion" in the "combination" of the words "that §362(a)(3) halts any affirmative act that would alter the status quo as of the time of the filing of a bankruptcy petition."

Justice Alito said that words in Section 362(a)(3) by themselves did not "definitively rule out" the result reached in the Seventh Circuit. "Any ambiguity" in that section, he said, "is resolved decidedly in" Chicago's favor by Section 542.

In view of Section 542, Justice Alito said that reading Section 362(a)(3) to proscribe "mere retention of property" would create two problems.

First, a broad reading of Section 362(a)(3) would "largely" render Section 542 "superfluous." Second, it would make the two sections contradictory. Where Section 542 has exceptions, Section 362(a)(3) has none.

Justice Alito observed that the prohibition against "control" over estate property was added to Section 362 in the 1984 amendments. "But transforming the stay in §362 into an affirmative turnover obligation would have constituted an important change," he said.

It "would have been odd for Congress to accomplish that change by simply adding the phrase 'exercise control,' a phrase that does not naturally comprehend the mere retention of property and that does not admit of the exceptions set out in §542," Justice Alito said.

Justice Alito interpreted the 1984 amendment to mean that it "simply extended the stay to acts that would change the *status quo* with respect to intangible property and acts that would change the *status quo* with respect to tangible property without 'obtain[ing]' such property."

Justice Alito ended his decision by noting what the opinion did not decide. The ruling did not "settle the meaning of other subsections of §362(a)" and did "not decide how the turnover obligation in §542 operates."

"We hold only that mere retention of estate property after the filing of a bankruptcy petition does not violate §362(a)(3) of the Bankruptcy Code." Justice Alito vacated the Seventh Circuit's judgment and remanded for further proceedings.

Justice Sotomayor's Concurrence

Justice Sotomayor said she wrote "separately to emphasize that the Court has not decided whether and when §362(a)'s other provisions may require a creditor to return a debtor's property." She said that the "the City's conduct may very well violate one or both of these other provisions," referring to subsections 362(a)(4) and (6).

In her six-page concurrence, Justice Sotomayor noted that the Court had not "addressed how bankruptcy courts should go about enforcing creditors' separate obligation to 'deliver' estate property to the trustee or debtor under §542(a)."

Although Chicago's conduct may have satisfied "the letter of the Code," she said that the city's policy "hardly comports with its spirit." She went on to explain why returning a car quickly is important so a debtor can commute to work and make earnings to pay creditors under a chapter 13 plan.

"The trouble" with Section 542, Justice Sotomayor said, is that "turnover proceedings can be quite slow" because they entail commencing an adversary proceeding. She ended her concurrence by saying that either the Advisory Committee on Rules or Congress should consider amendments "that ensure prompt resolution of debtors' requests for turnover under §542(a), especially where debtors' vehicles are concerned."

Observations

Prof. Ralph Brubaker agreed with the opinion of the Court. He told ABI that the "Court emphatically confirms the fundamental principle that the text of the automatic stay provision must be interpreted consistent with its most basic and limited purpose of simply maintaining the petition-date status quo. As Judge McKay put it in his *Cowen* opinion for the Tenth Circuit, 'Stay means stay, not go.' That guiding principle should also prove determinative in resolving the potential applicability of § 362(a)(4) and (a)(6), which the Court expressly refused to address."

Prof. Brubaker is the Carl L. Vacketta Professor of Law at the University of Illinois College of Law.

Rudy J. Cerone agreed. He told ABI that Justice Alito reached "the correct result under the history and structure of sections 362(a) and 542." He noted that the ABI Consumer Commission recommended speeding up turnover proceedings. Mr. Cerone is a partner with McGlinchey Stafford PLLC in New Orleans.

Significantly, the Court did not rule on whether debtors could achieve the same result under subsections (4) and (6) of Section 362(a), which prohibit an act to enforce a lien on property and an act to recover a claim.

In one of the cases before the Supreme Court, the bankruptcy court had relied on those other subjections in ruling for the debtor. The Supreme Court did not address subsections (4) and (6) because the Seventh Circuit did not reach those issues.

Consequently, debtors might resurrect a victory either through speedy procedures under Section 542 or a favorable interpretation of subsections (4) and (6). Reliance on the other subsections may not prevail given how Justice Alito would not permit Section 362 to perform all of the work of Section 542.

It is noteworthy how Justice Alito was skeptical that Congress would make major changes in a statute by using only a few words. At the same time, the Supreme Court has been reluctant in recent years to give importance to legislative history. Since legislative history might not succeed in altering the Supreme Court's view of the law, Congress evidently needs to attach bells and whistles to an amendment meant to change the law.

The case is *City of Chicago v. Fulton*, 19-357, 2021 BL 12454, 2021 Us Lexis 496 (Sup. Ct.).

Decided Last Term

Building on Bullard, the Supreme Court rules unanimously that a lift-stay motion is a "procedural unit" that's appealable if the bankruptcy court "conclusively" denies the motion.

Supreme Court Rules that 'Unreservedly' Denying a Lift-Stay Motion Is Appealable

The Supreme Court ruled unanimously today in *Ritzen v. Jackson Machinery* that an order denying a motion to modify the automatic stay is a final, appealable order "when the bankruptcy court unreservedly grants or denies relief."

In her unanimous opinion for the Court, Justice Ruth Bader Ginsburg said that a lift-stay motion is a "procedural unit" separate from the remainder of the bankruptcy case, even though the decision to retain the stay may be "potentially pertinent to other disputes."

The decision in *Ritzen* may contain a trap for creditors: A bankruptcy court could deny a creditor the right to appeal, perhaps for an extended time, by denying a lift-stay motion without prejudice or offering to reexamine the result in light of subsequent events.

The Facts

Before bankruptcy, the creditor had a contract to buy land from the debtor. The deal never closed, and the creditor sued in state court for breach of contract. Before trial, the debtor filed a chapter 11 petition.

In bankruptcy, the creditor moved to modify the stay so that the state court could decide who breached the contract. The bankruptcy court denied the motion. The creditor did not appeal.

The creditor filed a proof of claim, but the bankruptcy court disallowed the claim, ruling that the creditor, not the debtor, had breached the contract. Without objection from the creditor, the bankruptcy court confirmed the debtor's plan.

The creditor then filed an appeal from denial of the lift-stay motion and from disallowance of the claim. The district court dismissed the stay appeal as untimely and upheld the claim ruling on the merits.

The Sixth Circuit affirmed. *Ritzen Group Inc. v. Jackson Masonry LLC (In re Jackson Masonry LLC)*, 906 F.3d 494 (6th Cir. Oct. 16, 2018). To read ABI's analysis of the Sixth Circuit's opinion, click here.

The creditor filed a petition for *certiorari*, contending there was a split of circuits. The Supreme Court granted *certiorari* in May. The case was argued on November 13.

Bankruptcy Isn't Like Ordinary Litigation

Appealability is governed by 28 U.S.C. § 158(a), which gives district courts jurisdiction over appeals from "final judgments, orders, and decrees . . . in cases and proceedings referred to bankruptcy judges . . . ."

Justice Ginsburg acknowledged that ordinary rules of finality are "not attuned to the distinctive character of bankruptcy litigation." Bankruptcy, she said, is "an aggregation of individual controversies," quoting the *Collier* treatise. She explained why appeals from individual controversies cannot await resolution of the entire bankruptcy case.

The outcome was guided, if not controlled, by *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015), where the Supreme Court held that denial of confirmation of a chapter 13 plan is not a final, appealable order. She paraphrased *Bullard* as holding that bankruptcy court orders are final when they "definitively dispose of discrete disputes within the overarching bankruptcy case."

To be final under *Bullard*, an order must alter the *status quo* and fix the rights and obligations of the parties, Justice Ginsburg said.

Justice Ginsburg framed the question as whether denial of a lift-stay motion is a "distinct proceeding" that terminates "when the bankruptcy court rules dispositively on the motion." She said that a majority of courts and leading treatises say that denial of a lift-stay motion is immediately appealable.

Addressing the facts of the case on appeal, Justice Ginsburg said that the lift-stay motion was "a procedural unit anterior to, and separate from, claim-resolution proceedings." Stay relief, she said, "occurs before and apart from proceedings on the merits of creditors' claims."

Of potential significance in the future on questions about the finality of other types of orders, Justice Ginsburg said that resolution of a stay motion "can have large practical consequences." For example, leaving the stay in place may "delay collection of a debt or cause collateral to decline in value."

The decision by Justice Ginsburg is a categorical ruling. She saw "no good reason to treat stay adjudication as the relevant 'proceeding' in only a subset of cases." Quoting Supreme Court

authority in another context, she said that finality "should 'be determined for the entire category to which a claim belongs.' *Digital Equipment Corp. v. Desktop Direct Inc.*, 511 U.S. 863, 868 (1994)."

Justice Ginsburg left little room for contending that denial of a lift-stay motion can sometimes be non-final. She said it "does not matter whether the court rested its decision on a determination potentially pertinent to other disputes in the bankruptcy case, so long as the order conclusively resolved the movant's entitlement to the requested relief."

In a footnote at the end of the opinion, Justice Ginsburg said the Court was not deciding whether denial of a motion without prejudice would be final if the bankruptcy court was awaiting "further developments [that] might change the stay calculus."

Affirming the judgment of the Sixth Circuit, Justice Ginsburg held that the stay-relief motion was the "appropriate 'proceeding.'" The order "conclusively denying" the motion was final, she said, because the "court's order ended the stay-relief adjudication and left nothing more for the Bankruptcy Court to do in that proceeding."

Observation

At first blush, the opinion seems beneficial for creditors by assuring them of their right to appeal denials of lift-stay motions. In practice, however, *Ritzen* can be used against creditors.

Suppose the bankruptcy court denies a lift-stay motion without prejudice, saying that unfolding events might persuade the court to modify the stay. Denial of a motion without prejudice could therefore cut off the ability to appeal, exerting leverage in favor of the debtor and persuading the creditor to settle.

In upcoming years, courts may be called upon to grapple with the question of whether denial without prejudice may sometimes have the trappings of a final order.

The opinion is *Ritzen Group Inc. v. Jackson Masonry LLC*, 140 S. Ct. 582, 205 L. Ed. 2d 419 (Sup. Ct. Jan. 14, 2020).

High court rules that federal courts may make federal common law only to protect 'uniquely' federal interests.

Supreme Court Uses a Bankruptcy Case to Limit the Use of Federal Common Law

The Supreme Court ruled in *Rodriguez v. Federal Deposit Insurance Corp.* 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.

In his eight-page opinion for the unanimous court on February 25, Justice Neil M. Gorsuch used a dispute in bankruptcy court to hold that "cases in which federal courts may engage in common lawmaking are few and far between."

The Facts

A bank's holding company was in chapter 7 with a trustee. The bank subsidiary was taken over by the Federal Deposit Insurance Corp. as receiver. The bank subsidiary's losses resulted in a $4 million tax refund payable to the parent under a pre-bankruptcy tax allocation agreement, or TAA, between the parent and the bank subsidiary.

Both the trustee for the holding company and the FDIC, as receiver for the bank, laid claim to the refund. If the holding company owned the refund, the FDIC would have nothing more than an unsecured claim.

The bankruptcy court in Colorado granted summary judgment in favor of the holding company's trustee, concluding that the TAA did not create a trust or agency under Colorado law. In the view of the bankruptcy court, the parent and subsidiary only had a debtor/creditor relationship under the TAA, leaving the FDIC with an unsecured claim for the refund.

On appeal, the district court believed that the Tenth Circuit had adopted the *Bob Richards* rule, first enunciated by the Ninth Circuit in *In re Bob Richards Chrysler-Plymouth Corp.*, 473 F.2d 262 (9th Cir. 1973). *Bob Richards* made a presumption under federal common law that the subsidiary with the losses is entitled to the refund absent a TAA that clearly gives the refund to the parent.

The district court, however, went on to analyze the TAA and found provisions supporting a ruling in favor of the holding company and other provisions where the bank subsidiary would come out on top. The district court ended up relying on tie-breaking language in the TAA that

resolved ambiguity in favor of the bank subsidiary. The district court therefore reversed and awarded the refund to the FDIC.

The Tenth Circuit affirmed the district court, first saying that the appeals court had adopted *Bob Richards* in *Barnes v. Harris*, 783 F.3d 1185 (10th Cir. 2015).

Unlike *Barnes* and *Bob Richards*, the Tenth Circuit said that the case on appeal had a written agreement in the form of the TAA. The appeals court ruled that the tie-breaking provision in the TAA created an agency relationship. In the view of the circuit court, the FDIC was entitled to the refund because the holding company was an agent for the bank.

The Tenth Circuit created ambiguity about the basis for its ruling by saying at the end of the opinion that the result did not differ from the rule in *Barnes* and *Bob Richards*.

The circuits are split 3/4. The Fifth, Ninth and Tenth Circuits have followed *Bob Richards*, while the Second, Third, Sixth and Eleventh Circuits reject *Bob Richards* and employ state law to decide who owns a refund and whether the TAA creates an unsecured debtor/creditor relationship.

The holding company's trustee filed a petition for *certiorari* in April 2019. The Court granted the petition at the end of June to answer the one question presented: Does federal common law (*Bob Richards*) or state law determine the ownership of a tax refund?

Courts Have Only 'Limited Areas' for Making Federal Common Law

The handwriting was on the wall on the second page of the opinion. Justice Gorsuch said that state law — such as "rules for interpreting contracts, creating equitable trusts, avoiding unjust enrichment" — are "readymade" for deciding the ownership dispute.

"Judicial lawmaking," Justice Gorsuch said, "plays a necessarily modest role under a Constitution that vests federal" legislative power in Congress. As a result, "only limited areas exist in which federal judges may appropriately craft the rule of decision." Appropriate areas, he said, are in admiralty law and disputes among states.

Citing Supreme Court precedent, Justice Gorsuch said that federal common law is appropriate only when "necessary to protect uniquely federal interests." He found no federal interest in deciding the owner of the tax refund.

Returning to where he began, Justice Gorsuch said that "state law is well equipped to handle disputes involving corporate property rights." A federal bankruptcy, he said, "doesn't change much."

The Remedy

The trustee and the FDIC disagreed on whether the lower courts relied on *Bob Richards* or decided the case based on state law, but Justice Gorsuch said the Supreme Court did not grant *certiorari* to decide how the case should end up under state law.

Vacating and remanding, Justice Gorsuch said that the Court "took this case only to underscore the care federal courts should exercise before taking up an invitation to try their hand at common lawmaking."

Observations

The case is an example of how the Supreme Court will make law when the justices feel like it, even if there is no longer a dispute between the parties. By the time of oral argument, neither side nor the Solicitor General was defending the *Bob Richards* rule.

With no live controversy regarding *Bob Richards*, several justices made comments at oral argument suggesting that the Court might dismiss the petition as having been improvidently granted. For instance, Justice Ruth Bader Ginsburg said, "we usually don't decide an abstract" question when there is a lack of "adversarial confrontation."

However, several justices seemed primed to strike down *Bob Richards*. Justice Brett M. Kavanaugh said the federal common law was "patently indefensible." Hinting that he would be the author of the Court's opinion, Justice Gorsuch said at oral argument that the outcome should be determined by state law, without "any thumb on the scale by federal common law."

The opinion presents a question for bankruptcy judges: May they announce a rule of bankruptcy common law if the Bankruptcy Code does not provide an answer? Must courts always purport to find an answer in the statute?

The opinion is *Rodriguez v. Federal Deposit Insurance Corp.*, 18-1269 (Sup. Ct. Feb. 25, 2020).

Despite the high court's ban on nunc pro tunc orders, may bankruptcy courts make their orders retroactive?

Supreme Court Bans *Nunc Pro Tunc* Orders

The Supreme Court has banned the term "*nunc pro tunc*" from the bankruptcy lexicon.

In a *per curiam* opinion on February 24, the Court also ruled that a state court altogether lacks jurisdiction in a removed action until the case has been formally remanded. Merely terminating the basis for federal jurisdiction does not restore the state court's jurisdiction and power to act.

The Catholic Church in Puerto Rico filed a petition for *certiorari* in January 2019, contending that rulings by the Puerto Rico Supreme Court violated the Free Exercise and Establishment Clauses of the First Amendment. The Solicitor General filed a brief in December 2019 recommending that the Court grant *certiorari* and reverse the Puerto Rico Supreme Court.

Without holding argument, the Court granted the petition, reversed and remanded, but not on First Amendment grounds. Instead, the Supreme Court ruled that the Puerto Rico courts were without jurisdiction to enter orders at the critical time.

The Complex Facts

The facts and procedural history are complex, but they boil down to this: The Catholic Church in Puerto Rico terminated a pension plan for workers in the island's parochial schools. The workers sued in an island court. Reversing the intermediate appellate court, the Puerto Rico Supreme Court reinstated the orders of the trial court in favor of the workers by directing the church to deposit $4.7 million with the court. Another order directed the sheriff to seize church assets.

Based on the Treaty of Paris of 1898, the Puerto Rico Supreme Court believed that all church entities in Puerto Rico — including schools and parishes — are liable for the debts of their brother and sister Catholic institutions. Because the high court in Puerto Rico had disregarded the corporate separateness of Catholic entities, the church filed a petition for *certiorari*, raising complex questions under the First Amendment.

For the courts in Puerto Rico, there was a jurisdiction problem that had been overlooked. Before the trial court entered its orders to deposit money and seize assets, the church had removed the suit to federal court, contending that it was related to a bankruptcy case that had been filed by the schools' pension trust.

Nothing Happened

The exact timing of events in the island and federal courts was critical to the outcome in the Supreme Court.

On March 13, 2018, the bankruptcy court dismissed the pension trust's bankruptcy, thus ostensibly terminating the basis for removal of the suit against the church entities. Later in March 2018, the Puerto Rico trial court entered the orders to deposit money and attach assets, but the case had not yet been remanded to the island court when the orders were entered.

In fact, the federal court did not enter an order remanding the suit to the Puerto Rico court until August 2018, five months after the island court had entered orders *in that suit* to deposit money and attach assets. However, the remand order in August 2018 stated that it was *nunc pro tunc* to March 13, the day the bankruptcy was dismissed.

In Latin, the phrase means "now for then."

Jurisdiction Strictly Interpreted

A stickler for details, the Supreme Court ruled on the Puerto Rico court's lack of jurisdiction without reaching the merits on the First Amendment.

Because the suit had not been remanded to the island court when the orders were entered, the Supreme Court ruled in its eight-page opinion that the Puerto Rico court "had no jurisdiction over the proceedings. The orders are therefore void."

Citing 19th century authority, the Court said that removal divests the state court of "'all jurisdiction over the case, and, being without jurisdiction, its subsequent proceedings and judgment [are] not . . . simply erroneous, but absolutely void.'" *Kern v. Huidekoper*, 103 U.S. 485, 493 (1881).

The federal court's *nunc pro tunc* order did not save the day. The high court said that a *nunc pro tunc* order may "'reflect[] the reality'" of what has occurred, citing *Missouri v. Jenkins*, 495 U.S. 33, 49 (1990). A *nunc pro tunc* order, the Court said, "presupposes" that a court has made a decree that was not entered on account of "inadvertence," citing *Cuebas y Arredondo v. Cuebas y Arredondo*, 223 U.S. 376, 390 (1912).

The Supreme Court said that nothing had occurred in the federal court in terms of remand on March 13, the date to which the court had made the remand *nunc pro tunc*. Therefore, the high court ruled that a "court 'cannot make the record what it is not,'" citing *Jenkins*, 495 U.S. at 49.

What Does It Mean for Bankruptcy?

Bankruptcy courts often make orders *nunc pro tunc*. Based on the Supreme Court's opinion, a *nunc pro tunc* order is proper only if the court announces its ruling without immediate entry of an order.

May a bankruptcy court nonetheless make an order retroactive? For example, a retention order at the outset of a case may not be entered for several days or weeks. May retention be made retroactive to the date the application was filed, assuming it was later granted? Or, will courts be required to enter provisional orders immediately?

The opinion is *Roman Catholic Archdiocese of San Juan v. Acevedo Feliciano*, 140 S. Ct. 696, 206 L. Ed. 2d 1 (2020) (Sup. Ct. Feb. 24, 2020).

The Supreme Court reversed the First Circuit, which had held that the Oversight Board violated the Appointments Clause because the members were not appointed by the President and confirmed by the Senate.

Supreme Court Finds No Appointment Clause Violation in Puerto Rico's Oversight Board

Although the members of the Financial Oversight and Management Board of Puerto Rico were not nominated by the President nor confirmed by the Senate, the Supreme Court ruled on June 1 that the appointment of the Board did not violate the Appointments Clause of the Constitution because they exercise "primarily local duties."

All of the justices agreed in the judgment reversing the First Circuit, which had held that the Board's appointment violated the Appointments Clause. The decision by the high court means there will be no lingering doubt about the validity of Puerto Rico's debt arrangement.

Justice Stephen G. Breyer wrote the opinion of the court.

Justices Clarence Thomas and Sonia Sotomayor concurred in the judgment, which means they agreed with the result but for different reasons. In her opinion, Justice Sotomayor raised but did not answer questions about the ability of Congress to set aside Puerto Rico's democratically elected government by appointing a federal board to take over the island commonwealth's fiscal powers and responsibilities.

The Creation and Appointment of the Oversight Board

The Supreme Court ruled in June 2016 that Puerto Rico was ineligible for chapter 9 municipal bankruptcy. To allow the island commonwealth to restructure its unsupportable debt, Congress almost immediately adopted the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*).

The members of the Oversight Board were not nominated by the President nor were they confirmed by the Senate. Rather, PROMESA allowed the President to appoint one member of the Oversight Board. The President selected six more from a list of candidates provided by leaders of Congress. If any members appointed by the President were not on the congressional list, Senate confirmation would have been required. Since the six were all on the list, there was no Senate confirmation.

The Oversight Board commenced debt-adjustment proceedings for the commonwealth and its instrumentalities beginning on May 3, 2017, in district court in Puerto Rico. Aurelius Investment LLC and affiliates filed a motion in August 2017 seeking dismissal of Puerto Rico's debt-arrangement proceedings, arguing that the filing of the petition on behalf of the Commonwealth of Puerto Rico by the Board under Title III of PROMESA violated the Appointments Clause. The Oversight Board, the official unsecured creditors' committee, and COFINA bondholders, among others, opposed Aurelius.

Designated by the Chief Justice and sitting in the District of Puerto Rico to preside over the PROMESA proceedings, District Judge Laura Taylor Swain of New York handed down an opinion in July 2018 holding the Board was properly constituted under the Territories Clause of the Constitution, Article IV, Section 3, Clause 2. *In re Financial Oversight and Management Board for Puerto Rico*, 318 F. Supp. 3d 537 (D.P.R. July 13, 2018). To read ABI's discussion of the district court opinion, click here.

The First Circuit Reversal

On appeal, the First Circuit reversed, holding that the appointment of the members of the Oversight Board violated the Appointments Clause because they were not nominated by the President and confirmed by the Senate. Relying on the *de facto* officer doctrine, the appeals court went on to rule that its opinion would "not eliminate any otherwise valid actions of the Board prior to the issuance of our mandate in this case." *Aurelius Investment LLC v. Commonwealth of Puerto Rico*, 915 F.3d 838 (1st Cir. Feb. 15, 2019). For ABI's report on the First Circuit opinion, click here.

The appeals court entered an order that operated as a stay to remain in effect until the Supreme Court ruled on the case.

The Oversight Board filed a petition for *certiorari* in April 2019. Four other petitions followed, by the U.S. Solicitor General, Aurelius, the official creditors' committee, and a labor union in Puerto Rico.

The Supreme Court granted *certiorari* on June 20 to decide two questions: (1) Should the members of the Oversight Board have been nominated by the President and confirmed by the Senate; and (2) if the appointment was unconstitutional, does the *de facto* officer doctrine validate actions already taken by the Oversight Board?

Oral argument took place on October 15. To read ABI's report on oral argument, click here.

In retrospect, two issues raised by the justices at oral argument presaged the result: (1) Were they to uphold the First Circuit, some justices were concerned that the precedent would undermine

the governance of the District of Columbia and the territories; and (2) Counsel for the Oversight Board and the bondholders agreed that the case turned on whether the Board acted primarily locally or primarily nationally.

Counsel for the Board argued that its members were performing primarily local functions because they were supplanting Puerto Rico's legislature and governor. The bondholders contended that the Board's functions were national in scope because the proceedings would affect billions of dollars of investments and investors throughout the country who held the debt.

The Opinion for the Court by Justice Breyer

The Appointments Clause of the Constitution, Art. II, §2, cl. 2, provides that the President "shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the supreme Court, and all other Officers of the United States . . . ."

To decide whether Board members are Officers of the U.S., Justice Breyer — like Justice Thomas — leaned heavily on eighteenth century history and actions taken by Congress in dealing with territories immediately after adoption of the Constitution.

Justice Breyer quickly made a distinction between "ordinary" officers of the U.S. to whom the Appointments Clause applies and officers of the District of Columbia and the territories to whom the clause may nor may not apply in view of Article I, §8, cl. 17, pertaining to the District, and Article IV, §3, cl. 2, applicable to territories.

Justice Breyer did not leave the reader wondering about the result.

On the first page of his 22-page decision, he said that the "Board's statutory responsibilities consist of primarily local duties, namely, representing Puerto Rico in bankruptcy proceedings and supervising aspects of Puerto Rico's fiscal and budgetary policies." He held "that the Board members are not 'Officers of the United States.' For that reason, the Appointments Clause does not dictate how the Board's members must be selected."

Justice Breyer did not disagree entirely with the First Circuit. He agreed with the Boston-based appeals court to the extent that "Appointments Clause restricts the appointment of all officers of the United States, including those who carry out their powers and duties in or in relation to Puerto Rico."

In other words, he held that the clause applies to "*all* 'Officers of the U.S,' . . . even when those officers exercise power in or related to Puerto Rico." [Emphasis in original.] Although the Appointments Clause applies to officers of the District of Columbia and the territories, he limited the holding by saying that the clause "*does not* restrict the appointment of local officers that

Congress vests with primarily local duties under Article IV, §3, or Article I, §8, cl. 17." [Emphasis in original.]

Justice Breyer then turned to the question of whether the Board's powers and duties were primarily local. Parsing PROMESA, he concluded that "the Board's members have primarily local duties, such that their selection is not subject to the constraints of the Appointments Clause."

Rejecting the bondholders' reliance on the nationwide effect of the Board's decisions, Judge Breyer said that "[t]aking actions with nationwide consequences does not automatically transform a local official into an 'Officer of the U.S.'" The "same might be said of any major municipal, or even corporate bankruptcy."

Basing the ruling on the Appointments Clause, Justice Breyer avoided having to overrule the so-called Insular Cases from the very early twentieth century, which have been criticized for justifying colonialism. He was also not required to opine on the *de facto* officer doctrine.

The Concurrence by Justice Thomas

In his 11-page opinion, Justice Thomas agreed there was no violation of the Appointments Clause. However, he could not agree with the majority's "dichotomy between officers with 'primarily local versus primarily federal' duties," which he called an "amorphous test."

Instead, Justice Thomas relied on his understanding of the "original meaning" of the Appointments Clause. In his view, Board members are territorial officers performing duties under Article IV of the Constitution and "are not federal officers within the original meaning of that phrase . . . ."

Justice Thomas would also reverse the First Circuit, because the Board's members perform duties under Article IV and thus "do not qualify as 'Officers of the U.S.'" In his view, the majority's "primarily local" test would enable Congress to evade the Appointments Clause "by supplementing an officer's federal duties with sufficient territorial duties, such that they become 'primarily local,' whatever that means."

The Concurrence by Justice Sotomayor

The opinion by Justice Sotomayor is required reading for anyone concerned about depriving residents of Puerto Rico of their constitutional rights. She focused on the 1950 compact with Puerto Rico, enacted by Congress as Pubic Law 600, where residents of the island were given the right of self-governance.

In her 24-page opinion, Justice Sotomayor repeatedly asked whether Congress had the right to take away Puerto Rico's self-governance once residents of the island had been ability to elect their

own officials. At a minimum, she questioned whether taking away rights of self-governance turned the Board members into federal officials.

The board members "exist in a twilight zone of accountability," Justice Sotomayor said, because they were "neither selected by Puerto Rico itself nor subject to the strictures of the Appointments Clause. I am skeptical that the Constitution countenances this freewheeling exercise of control over a population that the Federal Government has explicitly agreed to recognize as operating under a government of their own choosing, pursuant to a constitution of their own choosing."

Justice Sotomayor "reluctantly" concurred in the judgment because, in her view, the most important issues were not presented in the case. She saw the case as raising a "serious questions about when, if ever, the Federal Government may constitutionally exercise authority to establish territorial officers in a Territory like Puerto Rico, where Congress seemingly ceded that authority long ago to Puerto Rico itself."

The opinion is *Financial Oversight and Management Board for Puerto Rico v. Aurelius Investment LLC*, 18-1334 (Sup. Ct. June 1, 2020).

The 'fraud-specific discovery rule' might permit FDCPA suits filed more than one year after the occurrence that gives rise to the claim.

Supreme Court Might Allow FDCPA Suits More than a Year After Occurrence

While closing one door, the Supreme Court opened another door today for debtors to argue that the statute of limitations does not begin to run until discovery of the existence of a claim under the federal Fair Debt Collection Practices Act, or FDCPA, 15 U.S.C. § 1692-1692p.

In 2008, a debt collector filed suit on a defaulted credit card debt. Later that year, the debt collector withdrew the suit because the complaint had been served on someone who was not the debtor at a home where the debtor was no longer living.

In 2009, the debt collector sued a second time, again serving someone not the debtor at the same address where the debtor was no longer living. There being no answer, the debt collector got a default judgment.

The debtor did not learn about the second suit until 2014, when he was denied a mortgage on account of the default judgment. Less than one year after discovery, the debtor filed suit, raising a claim under the FDCPA because the debt was allegedly time-barred. He contended that the one-year statute of limitations under the FDCPA was equitably tolled because the debt collector used a manner of service designed to ensure that the debtor would not receive service.

The Circuit Split

The district court dismissed the suit under the statute of limitations and was upheld in the Third Circuit. The Supreme Court granted *certiorari* to resolve a split of circuits.

In 2009, the Ninth Circuit had applied the so-called discovery rule in holding that limitations periods in federal practice generally begin to run when the plaintiff knows or has reason to know of the injury. *Mangum v. Action Collection Serv., Inc.*, 575 F.3d 935 (9th Cir. 2009).

En banc, the Third Circuit rejected the Ninth Circuit's holding by ruling that the statute begins to run when the violation occurs.

The Majority Opinion

Ostensibly, the case was governed by Section 1692k(d) of the FDCPA, which provides that suit must be brought "within one year from date on which the violation occurs."

Justice Clarence Thomas upheld the judgment of the Third Circuit in an opinion on December 10. Based on "dictionary definitions" of the words "violation" and "occurs," he said that the statute "unambiguously sets the date of the violation as the event that starts the one-year limitations period."

Justice Thomas described the Ninth Circuit's "discovery rule" as a "bad wine of recent vintage," citing a concurring opinion by the late Justice Antonin Scalia. According to Justice Thomas, "'Atextual judicial supplementation is particularly inappropriate when, as here, Congress has shown that it knows how to adopt the omitted language or provision."

In his brief, the debtor argued for the Court to follow a fraud-specific discovery rule with roots in 19th century Supreme Court precedent. *Bailey v. Glover*, 21 Wall. 342 (1875).

Justice Thomas did not reach the fraud-specific discovery rule. He said the debtor had not preserved the issue in the Ninth Circuit and did not raise the question in his petition for *certiorari*.

The Ginsburg Dissent

Justice Ruth Bader Ginsburg dissented from the judgment affirming the Third Circuit. She believes the debtor had preserved the issue in the appeals court and adequately raised the question in the *certiorari* petition.

Justice Ginsburg described the debt collector as having "employed fraudulent service to obtain and conceal the default judgment that precipitated [the debtor's] FDCPA claim."

"That allegation, if proved," she said, "should suffice under the fraud-based discovery rule, to permit adjudication of [the debtor's] claim on its merits."

The Sotomayor Concurrence

For future litigation on the FDCPA's statute of limitations, the concurring opinion by Justice Sonia Sotomayor is the most significant.

Justice Sotomayor agreed with the majority that the statute "typically" begins to run when the violation occurs, not when the debtor discovers the violation.

Unlike Justice Ginsburg, Justice Sotomayor also agreed with the majority that the debtor had not preserved the "equitable, fraud-specific discovery rule" in the Third Circuit. She therefore concurred in the judgment.

Justice Sotomayor wrote separately, she said, "to emphasize that this fraud-specific equitable principle is not the 'bad wine of recent vintage' of which my colleagues speak." Rather, she said, "the Court has long 'recogni[zed]' and applied this 'historical exception for suits based on fraud.'"

Justice Sotomayor ended her concurrence by telling future litigants that "[n]othing in today's decision prevents parties from invoking that well-settled doctrine."

The opinion is *Rotkiske v. Klemm*, 140 S. Ct. 355, 205 L. Ed. 2d 291 (Sup. Ct. Dec. 10, 2019).

The Supreme Court uses a copyright case to explain why the bankruptcy exception to states' sovereign immunity is unique under the Constitution.

Supreme Court Explains Sovereign Immunity in Bankruptcy Cases

A decision on state sovereign immunity involving copyrights allowed the Supreme Court to explain the rationale underlying *Central Virginia Community College v. Katz*, 546 U.S. 356 (2006), the high court's authority largely abrogating states' sovereign immunity in bankruptcy cases.

Scholars will argue whether the Supreme Court's March 23 copyright decision modified *Katz*. The answer is, "Probably not much, if at all." However, the Court's discussion of *stare decisis* suggests that the justices are not likely to revisit *Katz*.

Seminole Tribe

The Court's seminal decision on state sovereign immunity is *Seminole Tribe of Florida* v. *Florida*, 517 U.S. 44 (1996). There, the justices laid down two hurdles for congressional abrogation of sovereign immunity.

First, Congress must abrogate sovereign immunity using "unequivocal statutory language." *Id*. at 56. Second, the Constitution must have a provision allowing Congress to encroach on the state's sovereign immunity.

Seminole Tribe was a 5/4 decision, with justices divided along ideological lines. It led to a concern that sovereign immunity would preclude bankruptcy courts from disallowing claims filed by states or allow states to disregard the discharge of claims.

Katz largely laid those concerns to rest. The high court held that proceedings to set aside a preference were not barred by sovereign immunity because bankruptcy proceedings are essentially *in rem*.

The Copyright Case

This term, the Supreme Court granted *certiorari* in *Allen v. Cooper* because the Fourth Circuit held that a federal statute was invalid.

Allen involved a photographer who had taken pictures of an early 18th century shipwreck that belonged to the State of North Carolina. The photographer copyrighted the pictures.

Years later, the state published photos, and the photographer sued for copyright infringement. The district court allowed the suit to go forward, ruling that Congress abrogated sovereign immunity for copyright infringement in the Copyright Remedy Clarification Act of 1990, or CRCA.

The Fourth Circuit reversed on an interlocutory appeal, holding that the CRCA was invalid as to copyrights.

The Supreme Court Decision

The result was largely a foregone conclusion. In *Florida Prepaid Postsecondary Ed. Expense Bd.* v. *College Savings Bank*, 527 U.S. 627 (1999), the Supreme Court ruled that the CRCA did not validly extinguish sovereign immunity with regard to patents.

In her March 23 opinion for the Court, Justice Elena Kagan surveyed the rationale behind *Seminole Tribe* and the limits on the power of Congress to abrogate sovereign immunity.

Because *Florida Prepaid* had invalidated the CRCA as to patents, it was a short hop for Justice Kagan to hold that the CRCA's abrogation of sovereign immunity was also invalid as to copyrights.

The Discussion of *Katz*

Opposing the conclusion reached by Justice Kagan, the photographer based much of his argument on *Katz*, another 5/4 decision, but with the more liberal justices in the majority this time. In short, Justice Kagan said that *Katz* was inapplicable to copyrights.

Florida Prepaid said that Congress could not use the power of Congress over patents in Article I to end sovereign immunity. Given that the Bankruptcy Clause of the Constitution is also in Article I, how does it follow that the Court reached a contrary conclusion in *Katz*?

Katz, Justice Kagan said, "held that Article I's Bankruptcy Clause enables Congress to subject nonconsenting States to bankruptcy proceedings (there, to recover a preferential transfer). We thus exempted the Bankruptcy Clause from *Seminole Tribe's* general rule that Article I cannot justify haling a State into federal court."

"In bankruptcy, we decided, sovereign immunity has no place," Justice Kagan said bluntly.

Everything in *Katz* "is about and limited to the Bankruptcy Clause; the opinion reflects what might be called bankruptcy exceptionalism. In part, *Katz* rested on the 'singular nature' of bankruptcy jurisdiction. That jurisdiction is, and was at the Founding, 'principally *in rem*' . . . ," Justice Kagan said. [Citation omitted.]

Justice Kagan continued, saying that "*Katz* focused on the Bankruptcy Clause's 'unique history.' The [Bankruptcy] Clause emerged from a felt need to curb the States' authority." [Citation omitted.] The Bankruptcy Clause, she said, "was *sui generis* . . . among Article I's grants of authority."

Justice Kagan went on to say that the Bankruptcy Clause "had a yet more striking aspect . . . . [T]he Court . . . went further [in *Katz* and] found that *the Bankruptcy Clause itself* did the abrogating . . . . Or stated another way, we decided that no congressional abrogation was needed because the States had already 'agreed in the plan of the Convention not to assert any sovereign immunity defense' in bankruptcy proceedings." [Emphasis in original; citations omitted.]

In other words, the states waived sovereign immunity in bankruptcies by having adopted the Constitution. In Justice Kagan's terms, sovereign immunity in bankruptcy is "governed by principles all of its own."

Stare Decisis

Writing about *Allen*, we would be remiss if we did not mention Justice Kagan's discussion of *stare decisis* and the dissent by Justice Clarence Thomas.

Finding no difference between patents and copyrights, Justice Kagan said that the Court could have no other result in view of *Florida Prepaid* and the principle of *stare decisis*.

To reverse one of the Court's own precedents, Justice Kagan said there must be special justification over and above a belief that the precedent was wrongly decided.

Justice Thomas concurred in the judgment because he saw *Florida Prepaid* to be "binding precedent." However, he disagreed with Justice Kagan's discussion of *stare decisis*.

Requiring "'special justification . . . does not comport with our judicial duty under Article III,'" Justice Thomas said, quoting one of his prior concurring decisions.

In a footnote, Justice Thomas said he continues to believe that *Katz* was "wrongly decided."

Finally, we note how the justices remain split on the larger questions regarding sovereign immunity.

In *Allen*, Justices Stephen G. Breyer and Ruth Bader Ginsburg concurred in the judgment. They believe that *Seminole Tribe* was wrongly decided. They concurred in the judgment because their "longstanding view has not carried the day."

The opinion is *Allen v. Cooper*, 18-877, 140 S. Ct. 994, 206 L. Ed. 2d 291 (Sup. Ct. March 23, 2020).

'Cert' Denied

The denial of 'cert' aids the Madoff trustee's quest to recover 100% of defrauded customers' cash losses.

Supreme Court Allows the *Madoff* Trustee to Sue Foreign Subsequent Transferees

The Supreme Court will not review a decision in the *Madoff* liquidation where the Second Circuit held that Sections 548 and 550 enable the trustee to sue foreign defendants for the recovery of fraudulent transfers, even if subsequent transfers occurred abroad.

The action by the Supreme Court on June 1 is important for the 2,600 customers who were defrauded by Bernard Madoff in his $17 billion Ponzi scheme. The denial of *certiorari* allows the Madoff trustee to revive almost 90 avoidance actions where the trustee will be seeking some $3.2 billion, before prejudgment interest.

The Madoff trustee, Irving Picard, has already recovered $14.3 billion and has made distributions representing about 70% of the cash that customers invested. He is holding $1 billion in cash toward future distributions.

The revivified lawsuits may permit the trustee to realize additional recoveries and settlements that could bring the recovery to 100% of customers' cash losses. The Madoff firm is being liquidated in bankruptcy court in New York under the Securities Investor Protection Act, which incorporates large swaths of the Bankruptcy Code, including the avoiding powers.

Josephine Wang, the president and chief executive of the Securities Investor Protection Corp., told ABI that the "Second Circuit's decision sends an important message: to those who seek to divest the U.S. court of jurisdiction by unlawfully taking customer money out of a U.S. bank account and sending it abroad, your efforts will fail."

Wang added, "This is a good day for investors."

The Trustee's Victory in the Second Circuit

District Judge Jed Rakoff withdrew the reference of hundreds of lawsuits to the bankruptcy court where the Madoff trustee was suing to recover fictitious profits that Madoff paid to so-called net winners, meaning investors who had taken more cash out of the Ponzi scheme than they had invested. Among other controversial decisions, Judge Rakoff ruled in July 2014 that Section 550 does not permit recovering from a subsequent foreign recipient of stolen funds, given comity and the presumption against extraterritorial application of U.S. statutes.

Judge Rakoff sent the case back to the bankruptcy judge, who was required eventually to dismiss lawsuits where Madoff had paid out stolen funds to offshore feeder funds. The feeder funds in turn distributed the cash to their supposedly foreign investors.

The Second Circuit reversed in February 2019. *See 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 about the Second Circuit decision, click here.

On the question of whether Sections 548 and 550 apply extraterritorially, the Second Circuit held that the relevant transfer was not foreign. Rather, the trustee was seeking to recover a fraudulent transfer that emanated in the U.S. from a Madoff account in New York. The appeals court did not buy the idea that the fraudulent transfer escaped the tentacles of a U.S. court just because the initial recipient was abroad and in turn transferred the stolen money to another foreign entity.

Picking up on an argument made by the Madoff trustee, the Second Circuit said it was closing a "loophole," because the district court's precedent would enable a fraudster to transfer property to a "foreign entity," thereby rendering the "property recovery-proof." *Id*. at 100.

The *Certiorari* Petition

With the looming reinstatement of lawsuits against them, defendants filed a petition for *certiorari* in August. *HSBC Holdings PLC v. Picard*, 19-277 (Sup. Ct.). The Madoff trustee responded at the end of October, opposing *certiorari* because there is no circuit split. The justices of the Supreme Court considered the *certiorari* petition at a conference on December 6 and asked the U.S. Solicitor General "to file a brief . . . expressing the views of the United States" about the merits of granting *certiorari*.

In the brief filed on April 10, the Solicitor General expressed his opinion that the Second Circuit correctly ruled on the issue and that there is no split of circuits. He therefore recommended that the Court deny the *certiorari* petition. The Solicitor General even said that "the large dollar amounts at issue here provide no sound basis for this Court's review."

Having received the opinion of the Solicitor General, the justices considered the *certiorari* petition at a conference on May 28. The following Monday, June 1, the Court denied the petition. As is typical, the justices did not give reasons for declining to recover the case.

To read the Solicitor General's brief, click here.

The case is *HSBC Holdings PLC v. Picard*, 19-277 (Sup. Ct.).

The Supreme Court declined to decide whether the automatic stay terminates automatically after a repeat filing as to all property or only property of the debtor.

The Automatic Termination of the Automatic Stay: Not Ready for Prime Time

The Supreme Court denied a petition for *certiorari* presenting a circuit split on Section 362(c)(3)(A) and the following question:

If a petition by an individual under chapters 7, 11 or 13 has been dismissed within one year, does the stay terminate automatically 30 days after a new filing only as to property of the debtor or as to property of both the debtor and the estate?

Eventually, the Supreme Court needs to resolve the split. Unfortunately, the case on *certiorari* was not a good vehicle, and the circuit courts have yet to explore the issue thoroughly.

The Split

In *Rose v. Select Portfolio Servicing Inc.*, 945 F.3d 226 (5th Cir. Dec. 10, 2019), the Fifth Circuit created a circuit split by holding that Section 362(c)(3)(A) only terminates the automatic stay as to property of the debtor, but not as to property of the estate. To read ABI's report, click here.

The Fifth Circuit parted company with *Smith v. State of Maine Bureau of Revenue Services (In re Smith)*, 910 F.3d 576 (1st Cir. Dec. 12, 2018), where the First Circuit adopted the position taken by the minority of lower courts in ruling that Section 362(c)(3)(A) terminates the automatic stay entirely, including property of the estate. To read ABI's discussion of *Smith*, click here.

Section 362(c)(3)(A) is a drafting mess. It uses the phrase "with respect to" three times. It provides that the automatic stay in Section 362(a) terminates 30 days after the most recent filing "with respect to any action taken with respect to a debt or property securing such debt . . . *with respect to the debtor* . . . ." [Emphasis added.]

The subsection was one of the attempts at reform in the 2005 BAPCPA amendments. It was aimed at individuals who file bankruptcy repeatedly to forestall creditors.

In an individual's bankruptcy, the debtor typically has little property, because almost everything is property of the estate at filing. Even exempt property (such as a home) is estate property until it is abandoned or the exemption is allowed.

Consequently, Section 362(c)(3)(A) means little reform if the stay only terminates as to the debtor's own property. The majority of courts to rule on the question decided that the stay did not terminate automatically as to estate property, meaning that a mortgage lender could not foreclose 30 days after a repeat filing.

The Two Camps

The courts are split into two camps. Those finding that the stay terminated entirely were endeavoring to foster the intent of Congress. Courts that followed the language of the statute held that the stay ended only with respect to the debtor's property.

The losing party in *Rose* filed a petition for *certiorari* in February. The respondent didn't dignify the petition with opposition papers until the Supreme Court requested a response. Once the opposition was filed, the Court considered the petition at a conference on June 25 and denied the petition on the following Monday, June 29.

While the petition was pending, Bankruptcy Judge Christopher M. Klein of Sacramento, Calif., wrote an opinion that may have helped persuade the Supreme Court to deny *certiorari*. *In re Thu Thi Dao*, 20-20742, 2020 BL 178217 (Bankr. E.D. Cal. May 11, 2020). To read ABI's report, click here. Judge Klein's opinion was generously cited and discussed in the respondent's opposition to the *certiorari* petition.

Judge Klein's opinion is the single best authority so far on the split. He copiously described how the broad automatic termination espoused by the First Circuit would wreak havoc in chapter 7 cases. He explained, for example, how the Section 341 meeting would not have been held before the stay terminates automatically in the First Circuit. Or, the debtor might not have filed schedules before the stay terminates.

Judge Klein is correct in saying that most opinions on the subject only examine the issue in the chapter 13 context. He explains how chapter 7 trustees and creditors generally would be harmed were the stay to terminate entirely.

For example, assume the debtor has a home with equity much larger than the homestead exemption. If the stay were to evaporate entirely, the secured lender could foreclose, nail down all the equity and leave other creditors out in the cold. Or, one creditor might attach unencumbered property, to the exclusion of other creditors.

In other words, the circuit courts have not fully developed the issues under Section 362(c)(3) in the chapter 7 context. Also, *Rose* was not an ideal vehicle for *certiorari* given the convoluted positions of the parties.

In other words, the issue needs to percolate further in the circuits before the justices tackle Section 362(c)(3). Who knows; the split might evaporate once the circuits recognize the effect of total stay termination in chapter 7 cases.

So far, only one bankruptcy case is on the Supreme Court's argument calendar for the term to begin in October 2020. We refer to *City of Chicago v. Fulton*, 19-357 (Sup. Ct.), where the Court will decide whether the automatic stay requires a creditor to turn over repossessed property immediately after the debtor files bankruptcy. To read the ABI reports, click here and here.

The petition for *certiorari* was *Rose v. Select Portfolio Servicing Inc.,* 19-1035 (Sup. Ct.).

RBG

Compassion and intellect mark the bankruptcy opinions and dissents by the late Justice Ruth Bader Ginsburg.

Homage to RBG: The Advocate for Consumers and Debtors

With one notable exception, the late Justice Ruth Bader Ginsburg was consistently a dissenter who would have given more protection for consumers and provided greater relief for debtors in bankruptcy. Her opinions exude compassion and intellect.

Justice Ginsburg, who is being interred this week at Arlington National Cemetery, wrote two particularly notable opinions, one at the beginning and the other at the end of her tenure. She also prominently dissented from *Stern v. Marshall*, the Supreme Court's most recent restriction on the constitutional powers of bankruptcy courts.

RBG's Opinions for the Court

Her last word on bankruptcy was the unanimous opinion in January in *Ritzen Group Inc. v. Jackson Masonry LLC*, 140 S. Ct. 582, 205 L. Ed. 2d 419 (Sup. Ct. Jan. 14, 2020), a case that gave greater definition to a final, appealable order in bankruptcy cases. Granting *certiorari* was itself surprising, because the Court had written another important opinion on finality only five years before in *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015).

In *Ritzen*, Justice Ginsburg provided a better theoretical framework and conceptual analysis of the characteristics of finality in bankruptcy cases.

The opinion by Justice Ginsburg with the most profound effect on bankruptcy was her 1997 opinion in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (June 16, 1997). There, she extended a helping hand to lenders by reversing the Fifth Circuit and holding that a chapter 13 debtor must pay the replacement cost for the collateral, not the value from foreclosure, to retain personal property.

A year after *Rash*, Justice Ginsburg was back in the debtor's camp, narrowing the grounds for denying discharge of a debt. In *Kawaauhau v. Geiger*, 523 U.S. 57 (March 3, 1998), she wrote the opinion for the unanimous court and said that "merely a deliberate or intentional act that leads to injury" is not enough to bar the discharge of a debt. Rather, there must be a "deliberate or intentional injury."

In *Harris v. Viegelahn*, 575 U.S. 510 (2015), the Fifth Circuit had ruled that undistributed wages in the hands of a trustee on dismissal of a chapter 13 case should be distributed to creditors to avoid giving the debtor a windfall.

Again writing for the unanimous Court, Justice Ginsburg reversed the Fifth Circuit and said that the "most sensible reading" of Section 348(f) calls for returning the wages to the debtor. She saw no windfall for the debtor. Instead, she believed the undistributed money was "a fraction of the wages [the debtor] earned and would have kept had he filed under chapter 7 in the first place."

RBG's Dissents

Justice Ginsburg wrote or joined the dissenters in eight bankruptcy cases, most notably *Stern v. Marshall,* 564 U.S. 462 (2011), where she sided with the four-justice dissent authored by Justice Stephen G. Breyer. *Stern* added complication and expense to many bankruptcy cases by narrowing the scope of core matters. Justices Breyer, Ginsburg, Sonia Sotomayor and Elena Kagan found no violation of the Constitution. Any intrusion on the powers of the district court was "*de minimis*," in their view.

Of recent vintage, Justice Ginsburg wrote the dissent in *Spokeo v. Robins*, 138 S. Ct. 931, 200 L. Ed. 2d 204 (2018), joined by Justice Sotomayor. In *Spokeo*, the conservatives on the Court appeared to be attempting to establish the proposition that a consumer has no standing to sue for violation of a duty imposed by Congress unless the consumer has sustained monetary damage.

Justice Ginsburg would have found enough concrete injury to sue just because the defendant had published incorrect information about the plaintiff.

In late 1999, Justice Ginsburg wrote the dissent in *Rotkiske v. Klemm*, 140 S. Ct. 355, 205 L. Ed. 2d 291 (Dec. 10, 2019), where she wrote for herself alone.

The majority in *Rotkiske* ruled that the statute of limitations on a claim under the Fair Debt Collection Practices Act can begin to run even before the consumer is aware of the violation. Justice Ginsburg believed that a fraud-based discovery rule would have the statute beginning to run only when the consumer became aware of the violation. For the majority, Justice Clarence Thomas called the rule "bad wine of recent vintage."

Justice Ginsburg wrote the dissent in the 6/3 decision in *Schwab v. Reilly*, 30 S. Ct. 2652, 177 L. Ed. 2d 234 (June 17, 2010), where she was joined by Chief Justice John G. Roberts, Jr., and Justice Breyer. The three justices took the majority to task for putting "no time limit constraints" on a bankruptcy trustee when it comes to objecting to objections.

RBG Joins Dissenters

In five cases, Justice Ginsburg sided with dissenters who would have favored debtors, consumers, or their attorneys.

- Joining a dissent by Justice Sonia Sotomayor, Justice Ginsburg would have allowed Puerto Rico to fashion a bankruptcy-like law for its instrumentalities since they were ineligible for chapter 9 bankruptcy relief. *Puerto Rico v. Franklin California Tax-Free Trust*, 136 S. Ct. 1938, 195 L. Ed. 2d 298 (2016).

- In *Baker Botts LLP v. Asarco LLC*, 576 U.S. 121, 135 S. Ct. 2158, 192 L. Ed. 2d 208, 83 U.S.L.W. 4428 (2015), Justice Ginsburg and two other justices would have allowed counsel for a chapter 11 debtor to file a fee application to recover fees expended in the successful defense of a fee application.

- Also in the camp with two other justices, Justice Ginsburg would have permitted a debtor to mount a claim under the Fair Debt Collection Practices Act against a creditor who files a proof of claim that was time-barred. *Midland Funding LLC v. Johnson*, 37 S. Ct. 1407, 197 L. Ed. 2d 790, 85 U.S.L.W. 4239 (2017).

- Joining a dissent by Justice John Paul Stevens, Justice Ginsburg would have allowed someone who was injured by asbestos to file a direct-action claim against insurers for the insurers' own misconduct. *Travelers Indemnity Co. v. Bailey*, 557 U.S. 137 (2009); and

- In *Hall v. U.S.*, 566 U.S. 506 (2012), Justice Ginsburg was on the short end of a 5/4 decision. For property sold after filing, she would have allowed a family farmer to pay capital gains tax as a general unsecured claim. Like three other justices, she believed that the majority reached a result that was the "very opposite of what Congress intended."

Reorganization

Fraudulent Transfers

The Supreme Court is considering whether to review another case defining the safe harbor in Section 546(e).

Detroit Judge Criticizes the Second Circuit's *Tribune* Decision on the Safe Harbor

This month, the Supreme Court sought the views of the U.S. Solicitor General regarding the grant or denial of a petition for *certiorari* challenging the Second Circuit's decision in the *Tribune* fraudulent transfer litigation. Despite the restrictive reading the Supreme Court gave to the safe harbor in *Merit Management Group LP v. FTI Consulting Inc.*, 138 S. Ct. 883 (Feb. 27, 2018), the Second Circuit persisted in immunizing a fraudulent transfer when a bank was involved in the chain of payments.

Deciding this week that the safe harbor was not applicable in a case similar to *Tribune*, Bankruptcy Judge Maria L. Oxholm of Detroit disagreed with the Second Circuit, made important pronouncements about the interpretation of Section 546(e) and provided reason for granting *certiorari* to review *Tribune*.

Judge Oxholm said that the Second Circuit had created a "complete workaround of *Merit Management*."

The Detroit Litigation

Judge Oxholm's decision arose from the bankruptcy of the Greektown casino in Detroit. The trustee of a litigation trust created under a chapter 11 plan brought claims alleging there was about $145 million in fraudulent transfers resulting from a leveraged buyout that occurred less than three years before the chapter 11 filing.

As usual, there were several banks and brokers playing various roles in the transaction. Of significance to Judge Oxholm's decision, a broker sold notes and distributed the proceeds to those who ended up as defendants in the fraudulent transfer suit.

Now retired, the bankruptcy judge then assigned to the case followed Sixth Circuit authority and granted the defendants' motion for summary judgment in 2015. He dismissed, ruling that the suit was precluded by the safe harbor in Section 546(e). The district court affirmed.

While the appeal was pending in the Sixth Circuit, the Supreme Court handed down *Merit Management*, impliedly overruling the Sixth Circuit decision on which the bankruptcy judge had

dismissed the suit. The Sixth Circuit vacated and remanded the *Greektown* decision for further consideration in view of *Merit Management*.

Judge Oxholm's 61-page opinion on October 19 was the culmination of the remand. Before we analyze her opinion, let's look at *Merit Management* and *Tribune*.

Merit Management

Merit Management raised the question of whether the presence of a financial institution as a conduit in the chain of payments in a leveraged buyout is sufficient to invoke Section 546(e).

Section 546(e) provides that "the trustee may not" sue for recovery of a "settlement payment" that was made "by or to (or for the benefit of) a . . . financial institution" unless the suit was brought under Section 548(a)(1)(A) for recovery of a fraudulent transfer within two years of bankruptcy made with actual intent to hinder, delay or defraud creditors.

The Supreme Court held that the safe harbor is for "financial institutions," not for transactions. More specifically, the Court ruled that Section 546(e) only applies to "the transfer that the trustee seeks to avoid." *Merit Management*, *id.*, at 888. In other words, sticking a bank or broker in the middle of a chain of payments from the transferor to the defendant does not invoke the safe harbor. To read ABI's report on *Merit Management*, click here.

Tribune

The Second Circuit's opinion arose from the chapter 11 reorganization of newspaper publisher Tribune Co.

Two years before *Merit Management*, the Second Circuit reversed the district court and dismissed the fraudulent transfer suit. The appeals court held that Section 546(e) impliedly preempted state fraudulent transfer law, under which the creditors were suing. It was sufficient to invoke the safe harbor, in the opinion of the appeals court, if a bank or financial institution was somewhere in the chain of payments.

The appeals court said that allowing fraudulent transfer suits to unwind "settled securities transactions" would "seriously undermine" the markets. *In re Tribune Co. Fraudulent Transfer Litigation*, 818 F.3d 98, 119 (2d Cir. 2016). To read ABI's report on the first *Tribune* opinion, click here.

The creditors in *Tribune* had filed a petition for *certiorari* before the Supreme Court handed down *Merit Management*. At the suggestion of a pair of justices on the Supreme Court, the Second Circuit withdrew the mandate in *Tribune* in May 2018 to revisit the issue.

Merit Management had overruled one of the grounds for the Second Circuit's belief that having a bank in the chain of payments is enough to invoke the safe harbor.

The Second Circuit handed down its new decision in December 2019. *In re Tribune Co. Fraudulent Transfer Litigation*, 946 F.3d 66 (2d Cir. Dec. 19, 2019). The result was the same: dismissal. The Second Circuit found a loophole in *Merit Management*.

The appeals court adhered to its original holding that the safe harbor in the Bankruptcy Code preempts state law. Upholding dismissal a second time, the panel concluded that the newspaper publisher was a "financial institution" as defined in Section 101(22)(A), thus making the safe harbor applicable.

How's that possible?

A "financial institution" in Section 101(22)(A) is defined to be a bank or "trust company, . . . and when any such . . . entity is acting as agent or a custodian for a customer . . . in connection with a securities contract . . . such customer." Translated into plain English, a customer of a financial institution itself becomes a "financial institution" if the financial institution is acting as the customer's agent or custodian.

Relying on information that was arguably not in the record on the motion to dismiss in district court, the appeals court ruled that a depositary used for making payments to selling shareholders in the leveraged buyout was an agent for Tribune.

Thus, Tribune fell within the definition of a "financial institution," making the safe harbor applicable and compelling dismissal of the suit. To read ABI's report on the second *Tribune* opinion, click here.

In July, the creditors filed a second petition for *certiorari*. *Deutsche Bank Trust Co. v. Robert R. McCormick Foundation*, 20-8 (Sup. Ct.). Several *amicus* briefs were filed. On October 5, the Supreme Court invited the Solicitor General to file a brief expressing the views of the government.

That leads us to the opinion by Judge Oxholm.

Identify the Transfer

The defendants in the Detroit litigation filed a motion for summary judgment, contending they were protected by the Section 546(e) safe harbor.

Judge Oxholm interpreted *Merit Management* to mean that she must identify the "'overarching transfer that the trustee seeks to avoid . . . .'" *Merit Management*, *id.*, at 892-93. She concluded

that the relevant transfer was from the transferor to the defendants. The trustee was not attacking any transfer to the broker.

Even if the transfer was not to the broker, the safe harbor would still apply under Section 546(e) if the transfer was "for the benefit of" the broker. In deciding whether the transaction was for the benefit of the broker, Judge Oxholm noted that the broker was paid several million dollars in fees for various services.

Citing circuit court authority, Judge Oxholm said that the transaction would be for the benefit of the broker if the broker "received a direct, ascertainable, and quantifiable benefit corresponding in value to the payments to Defendants."

Judge Oxholm held that the broker's fees were "insufficient" to make the transaction for the benefit of the broker. She said that the fees were "incidental" to the transaction and "do not correspond in value to the . . . transfers to the Defendants."

The Criticism of *Tribune*

Next, Judge Oxholm addressed the definition of "financial institution" in Section 101(22)(A). Recall that someone is a "financial institution" if a broker serves as their agent or custodian.

Without much analysis, the Second Circuit had held in the second *Tribune* opinion that a financial institution was acting as an agent for a party in the challenged transfer.

Judge Oxholm therefore analyzed whether the broker was anyone's agent. She said that both Michigan and federal law follow the Restatement (Third) of Agency to decide whether an agency was created. She said that an agent acts on behalf of a principal but must have authority to negotiate for the principal.

Judge Oxholm said she was "not persuaded by the agency analysis in *In re Tribune Co.* as it does not distinguish between mere intermediaries contracted for the purpose of effectuating a transaction and agents who are authorized to act on behalf of their customers in such transactions." Under *Tribune*, she said, "any intermediary hired to effectuate a transaction would qualify as its customer's agent . . . . This would result in a complete workaround of *Merit Management*."

Judge Oxholm continued, saying that "there must be a finding that a principal authorized the agent to act on its behalf. Otherwise, any service provider would qualify as an agent."

On the question of agency, Judge Oxholm made her ruling as a matter of law, because there was a written contract. The documents said that the broker was not an agent but was serving in other roles, such as financial advisor or independent contractor.

Judge Oxholm therefore held that the defendants "failed to establish an agency relationship" because they presented no evidence to "support the crucial elements of an agency relationship." The broker, she said, was only performing "contractual services."

Custodian

The defendants had another argument: The broker was their "custodian" as defined in Section 101(11). If a broker was acting as a custodian for the defendants, Section 101(22)(A) would transform the defendants into financial institutions protected by the safe harbor.

The defendants cited securities regulations to show that the broker was serving as a custodian. Judge Oxholm ruled that the definition of a custodian in Section 101(11) controlled, not the definition of a custodian elsewhere in federal law. She said it was "inappropriate to adopt and interpret a completely different definition."

Under Section 101(11)(C), a custodian is a "trustee, receiver, or agent . . . that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors."

Applying the Section 101(11)(C) definition, Judge Oxholm said that the broker did not have a lien and was not administering the property "for the benefit of *all*" creditors. [Emphasis in original.] She therefore held that the broker was not serving as a custodian in a fashion that would invoke the safe harbor.

In short, Judge Oxholm denied the defendants' motion for summary judgment and held that the safe harbor did not apply because the transfer was not to or for the benefit of a financial institution.

The opinion is *Buchwald Capital Advisors LLC v. Papas (In re Greektown Holdings LLC)*, 10-05712, 2020 BL 404608, 2020 Bankr Lexis 2938 (Bankr. E.D. Mich. Oct. 19, 2020).

Even if flip clauses are ipso facto clauses, the Second Circuit holds that enforcement is permitted by the safe harbor in Section 560.

Second Circuit Holds that Flip Clauses in Swaps Are Enforceable

Fourteen months after oral argument, the Second Circuit affirmed the lower courts by holding in a *per curiam* opinion that the safe harbor exception to the automatic stay in Section 560 permits enforcement of a so-called flip clause in a swap agreement.

The opinion is notable because it is arguably contrary to the Supreme Court's more narrow construction of other safe harbor provisions in the Bankruptcy Code. *See Merit Management Group LP v. FTI Consulting Inc.*, 138 S. Ct. 883 (Feb. 27, 2018).

The decision was costly for creditors of Lehman Brothers Holdings Inc. and its subsidiaries, who will lose perhaps $1 billion from the inability to enforce flip clauses. Had the flip clauses been unenforceable as *ipso facto* clauses, the proceeds from the liquidation of swap agreements would have gone first to Lehman. But the bankruptcy of Lehman was a default invoking the flip clauses, which first directed proceeds from the liquidation of the swaps to noteholders.

After paying noteholders, nothing was left for Lehman or its creditors.

The Lehman Flip Clauses

Lehman and its subsidiaries had thousands of swaps in their portfolios when they began filing for chapter 11 protection in September 2008. Before bankruptcy, Lehman was "in the money" and stood to recover from the termination of many of the swaps.

The flip clauses provided that the collateral securing the swaps would go first to Lehman as the swap counterparty in an ordinary maturity or termination.

If Lehman were to file bankruptcy and thus cause an event of default, the swap counterparty could terminate the swap prematurely. Since Lehman was the defaulting party, the flip clause directed the collateral proceeds first to noteholders, not to Lehman. Since the noteholders were never paid in full, Lehman got nothing when the flip clauses were invoked, even though Lehman would have been in the money had there been an ordinary maturity.

The Lawsuit in Bankruptcy Court

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

Five years into the adversary proceedings, the defendants filed motions to dismiss. Bankruptcy Judge Shelley C. Chapman granted the motions in June 2016, prompting Lehman to appeal. District Judge Lorna G. Schofield affirmed in March 2018. To read ABI's discussions of the opinions, click here and here.

Affirmance in the Second Circuit

Lehman appealed, and the Second Circuit heard oral argument in June 2019. The 26-page affirmance was handed down in a *per curiam* opinion on August 11. The panel consisted of Circuit Judges Dennis Jacobs, Susan L. Carney and Joseph F. Bianco.

The opinion began by reciting how the "Bankruptcy Code generally bars enforcement of '*ipso facto* clauses,' which trigger or modify payment obligations when a party seeks relief in bankruptcy." The panel cited the lower courts for holding that "section 560 of the Bankruptcy Code . . . , which creates a safe harbor for the liquidation of swap agreements, allowed the distribution of proceeds according to the [flip clauses,] whether or not those provisions are properly characterized as *ipso facto* clauses."

The circuit panel agreed.

Section 560 provides that the "exercise of any contractual right of any swap participant . . . to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) [an anti-*ipso facto* provision] of this title . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title . . . ."

For the panel, the primary question was whether the distribution of proceeds from liquidation of a swap pursuant to a flip clause "constitutes the 'liquidation' of a swap agreement under section 560."

The panel held that "that the term 'liquidation,' as used in section 560, must include the disbursement of proceeds from the liquidated Collateral." The panel said that reading "liquidation" in Section 560 "to include distribution of the Collateral furthers the statutory purpose of protecting swap participants from the risks of a counterparty's bankruptcy filing by permitting parties to quickly unwind the swap."

The panel said, "we reject [Lehman's] suggestion that *Merit Management*, a Supreme Court decision rendered after the Bankruptcy Court issued its ruling, invalidates the reasoning of either the Bankruptcy Court or the District Court. *Merit Management* analyzed a different safe harbor provision, 11 U.S.C. § 546(e)."

Affirming the lower courts, the panel held that "the term 'liquidation,' as used in section 560, is in our view broad enough to include the subordination of [Lehman's] payment priority and distribution according to the amended waterfall of payment priorities."

Because the panel held that the flip clauses were enforceable under the safe harbor in Section 560, the circuit court did not decide whether the flip clauses in fact are *ipso facto* clauses.

Observations

The Second Circuit in recent years has been protective of the interests of financial institutions. Its decision on the safe harbor in Section 546(e) was one of those overturned by *Merit Management*, a unanimous opinion written by Justice Sonia Sotomayor.

Merit Management significantly narrowed application of the safe harbor in Section 546(e) by holding that it only immunizes transfers where the ultimate transferor or transferee was a bank, broker or "financial participant." In other words, including a bank in the chain of payments to the ultimate transferee does not invoke the safe harbor. The bank or financial institution must have skin in the game before the safe harbor in Section 546(e) puts a fraudulent transfer beyond the reach of a bankruptcy trustee. To read ABI's report on Merit Management, click here.

Unanimously, *Merit Management* rejected the broad reading given by five circuits to the Section 546(e) safe harbor. Justice Sotomayor focused in significant part on "the plain language of the safe harbor." *Id.* at 897.

If there is a flaw in the Second Circuit's analysis, it's in the interpretation of the word "liquidation" in Section 560. The appeals court understands the word to mean both the liquidation of collateral and the distribution of proceeds.

Respectfully, liquidation of assets and distribution are different concepts dealt with in different provisions of the Bankruptcy Code. Arguably, the appeals court departed from the language of the statute by equating the two terms.

Liquidation of swap collateral is clearly permitted by Section 560, but distribution of proceeds to noteholders in excess of their economic rights arguably is not required to protect the swap parties or markets. To protect credit markets, did Congress intend for noteholders to receive a windfall at the expense of a debtor and its creditors?

The opinion is *Lehman Brothers Special Financing Inc. v. Branch Banking & Trust Co. (In re Lehman Brothers Special Financing Inc.)*, 18-1079 (2d Cir. Aug. 11, 2020).

Fictitious profits in account statements don't represent 'value' and give rise to a defense for receipt of a fraudulent transfer with 'actual intent,' the Second Circuit rules.

Second Circuit Upholds the Madoff Trustee's Calculation of Fraudulent Transfer Claims

Unless the Supreme Court reverses, the Second Circuit has now rejected the last nonfrivolous arguments preventing the trustee for the Bernard Madoff Ponzi scheme from recovering fictitious profits paid to customers within two years of bankruptcy.

The pertinent facts were simple, but the legal analysis was complex in the September 24 decision by Circuit Judge Robert D. Sack for the New York-based Court of Appeals.

"The Second Circuit's well-crafted decision makes clear that provisions of the Bankruptcy Code that undermine the goal of customer protection under the Securities Investor Protection Act will not apply," Josephine Wang told ABI. Wang is the president and chief executive of the Securities Investor Protection Corp. She commended "the Trustee and his team for their tireless pursuit of recoveries for the benefit of customers."

The Theory for Recovery of Fictitious Profits

Madoff never bought a single share of stock with customers' investments. Instead, he created fictitious account statements showing that his customers were earning handsome profits. When a customer sought a withdrawal, Madoff paid with money stolen from other customers, a classic Ponzi scheme.

The Ponzi scheme crashed in 2008, followed by a liquidation in bankruptcy court in New York under the Securities Investor Protection Act, 15 U.S.C. § 78aaa *et seq*. SIPA incorporates large swaths of the Bankruptcy Code to the extent not inconsistent with SIPA.

The Second Circuit recognizes the so-called Ponzi scheme presumption, which automatically turns customers into recipients of fraudulent transfers with "actual intent" except to the extent they have cognizable defenses. Customers who were only paid part of their principal investments in good faith received repayments of antecedent debts and therefore had defenses under Section 550(b)(1).

Customers who had recovered only part of their investments before bankruptcy were called net losers.

The Second Circuit appeal, on the other hand, involved so-called net winners, meaning customers who took more cash out of the Ponzi scheme than they had invested. The Madoff trustee sued net winners.

Through a multitude of complex litigations and appeals, the Second Circuit previously upheld the ability of the Madoff trustee to sue net winners for receipt of fraudulent transfers made with "actual intent" under Section 548(a)(1)(A). However, the trustee's recoveries were limited to transfers made within two years of bankruptcy.

Previously, the Second Circuit had also ruled that the trustee was correctly calculating net losers' so-called net equity claims: All of a customer's deposits since inception of the account were weighed against all of the customer's withdrawals. To the extent a customer took out less that he or she had invested, the customer had a net equity claim against what SIPA calls the fund of customer property. In substance, valid customer claims are paid ahead of the claims of general unsecured creditors from the fund of customer property and from advances by the Securities Investor Protection Corp.

The trustee used the same calculation to determine his fraudulent transfer recovery: He sued to recover fictitious profits taken out within two years of bankruptcy. Because Madoff never purchased any securities, the trustee calculated fictitious profits as the amount by which a customer's withdrawals since inception exceeded the customer's investments since inception. In other words, the trustee did *not* sue only to recover the excess of withdrawals made within two years of bankruptcy over cash taken out within two years of bankruptcy.

The district court granted summary judgment in favor of the trustee and allowed the calculation of fictitious profits to consider deposits and withdrawals going back to inception of the account, not just deposits and withdrawals within two years of bankruptcy. For customers in good faith because they did not know there was fraud, the trustee's recovery was limited to withdrawals within two years of bankruptcy.

The 'Value' Issue in the Second Circuit

Several customers appealed to the Second Circuit. Primarily, they made two arguments: (1) With regard to the defenses under Section 548(c), the customers contended they had a defense because they gave "value" and in good faith. For these particular customers, the trustee did not challenge their good faith. That is, they did not know a Ponzi scheme was afoot. (2) The customers argued that the trustee was improperly suing to recover transfers that occurred more than two years before bankruptcy, because their contractual rights to the payments accrued more than two years before bankruptcy.

Judge Sack devoted 26 pages of his 42-page opinion to explaining the prior district and circuit court Madoff rulings that were pertinent to the new appeal. In that respect, the opinion reads like a memorandum to the Supreme Court putting the new decision in context in case the customers file a petition for *certiorari*.

The Customers Gave No 'Value'

The customers argued that a prior holding by the Second Circuit means that they had given value arising from "securities entitlements" on account of the account statements they had received showing handsome but fictitious profits. Judge Katz said that his court had made no such ruling.

Even if the customers did have securities entitlements, he said "they did not have property rights to the values in excess of principal reflected there," based on the Uniform Commercial Code.

Next, the customers argued they had contract rights based on Section 29(b) of the Exchange Act of 1934, which allows a defrauded customer to void or enforce the contract. The theory, however, would conflict with the special priority system created under SIPA, where customers are paid from the fund of customer property ahead of unsecured creditors.

The customers' value defense, Judge Sack said, "would conflict with SIPA," because customers with no net equity claims would come out ahead of those who had valid net equity claims.

Judge Sack went on to explain how the value defense "operates differently in a SIPA liquidation." In an ordinary bankruptcy, he said, the value defense applies to any transfer made in exchange for value.

In a SIPA liquidation, on the other hand, a customer only has a claim against the fund of customer property related to net equity claims based on cash investments into the account. Since the transfers were not a return of customers' principal, Judge Sack said "they were transfers of fictitious profits in excess of principal that depleted the resources of the customer property fund without an offsetting satisfaction of a debt or liability of that fund."

Judge Sack therefore held that the customers did not give value to justify the defense in Section 548(c).

The Two-Year Limitation Didn't Apply

A valid fraudulent transfer claim under Section 548 only allows recovery of transfers within two years of bankruptcy. By basing the claim against net winners on withdrawals since the

inception of the account, the customers therefore argued that the trustee was recovering withdrawals more than two years before the filing date.

Judge Sack said that Madoff never actually purchased any securities. Thus, he said, Madoff "never generated any legitimate profits. The [customers] therefore had no rights to the transfers let alone rights that arose prior to the two-year limitation period."

Judge Sack pointed out that the two-year limitation appears in Section 548(a)(1), but not in Section 548(c), which creates the value defense.

The customers gave no value because the trustee was suing only to recover fictitious profits, not principal investments, Judge Sack said. He then held that "the trustee's claims under the actual fraud provision do not violate the statutory provision limiting recovery to transfers made within the two years prior to the filing of the petition."

'*Cert*' and 'PJI'

The customers might file a petition in the Supreme Court for *certiorari*. Granting the petition is unlikely because there is no circuit split, and the issue principally relates to SIPA liquidations of Ponzi schemes, which are infrequent.

The loss puts the customers at a turning point. The lawsuits against them began 10 years ago. If they do not settle now with the trustee, they face claims for prejudgment interest that could double the judgments in favor of the trustee.

The opinion is *Gettinger v. Picard (In re Bernard L. Madoff Investment Securities LLC)*, 19-0429 (2d Cir. Sept. 24, 2020).

The expansive definition of a 'financial institution' allows fraudulent transfers to be structured so that no one will ever be held liable.

New York Decision Shows that *Merit Management* Is a Dead Letter

Despite the Supreme Court's *Merit Management* decision, a bald-faced fraudulent transfer can still be immune from attack, at least in the Second Circuit, if the transaction was structured to use a financial institution as an agent for the defendant.

Merit Management was the landmark decision in February 2018, where the Supreme 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 so-called 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." In Section 101(22)(A), a financial institution includes a bank.

Merit Management held that Section 546(e) only applies to "the transfer that the trustee seeks to avoid." More particularly, Justice 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." *Merit Management Group LP v. FTI Consulting Inc.*, 138 S. Ct. 883, 888, 893 (Sup. Ct. Feb. 27, 2018).

Merit Management's Effect on *Tribune I*

Merit Management had the effect of abrogating one of the Second Circuit's principal holdings in *Note Holders v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litigation)*, 818 F.3d 98 (2d Cir. 2016), which we shall refer to as *Tribune I*. After what amounted to a remand from the Supreme Court following *Merit Management*, the Second Circuit amended its *Tribune I* opinion in what we shall refer to as *Tribune II*: *In re Tribune Co. Fraudulent Conveyance Litigation*, 946 F.3d 66 (2d Cir. Dec. 19, 2019).

Tribune I included two rulings by the Second Circuit that precluded creditors of a bankrupt company from bringing suit on their own behalf based on state fraudulent transfer law. First, the circuit court ruled that the safe harbor in Section 546(e) applied even if a bank only served as a conduit for money paid to selling shareholders in a leveraged buyout that turns out to be a fraudulent transfer. The appeals court said that the safe harbor protects transactions, not just financial institutions.

Merit Management had the effect of overturning the Second Circuit's holding that the safe harbor applies even if a bank only serves as a conduit for money paid to selling shareholders in a leveraged buyout that was a fraudulent transfer.

Tribune I had a second ground for dismissal: The Section 546(e) safe harbor impliedly preempts state law on fraudulent transfers anytime there is a bankruptcy of a company that was the subject of a leveraged buyout. As a result of federal preemption, the Second Circuit said that individual creditors cannot mount a fraudulent transfer suit on their own behalf.

The Loophole in *Merit Management*

In *Tribune II*, the Second Circuit in substance found a loophole in *Merit Management*: A defendant in a fraudulent transfer suit who cannot invoke the Section 546(e) safe harbor after *Merit Management* can still immunize the transaction from attack as a constructive fraudulent transfer under Section 548(a)(1)(B) by employing a "financial institution" as its "agent."

Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., was assigned to preside over a case in Manhattan under New York law alleging that a leveraged refinancing was a fraudulent transfer with "actual intent." Where the *Tribune* opinions involved constructively fraudulent transfers, Judge Grossman was dealt a case alleging "actual intent."

Leveraged transactions are always complex, and the case before Judge Grossman was no exception. Basically, a company took down $2.1 billion in new financing to pay its owners. Three years later, the company was in bankruptcy. Subordinate lenders in the leveraged financing received nothing in the resulting chapter 11 plan. All they got was the right to receive whatever a liquidating trustee might recover in lawsuits.

The creditors assigned their New York fraudulent transfer claims to the liquidating trustee, who sued defendants that were paid with proceeds from the leveraged refinancing. In his 82-page opinion on June 18, Judge Grossman granted the defendants' motion to dismiss.

Judge Grossman Follows *Tribune II*

Judge Grossman's opinion is "must reading" for anyone structuring a leveraged buyout or a leveraged refinancing. His decision highlights the structuring devices blessed by *Tribune II* that make a transaction immune from attack under the Section 546(e) safe harbor. Significantly also, Judge Grossman dissected *Merit Management* to explain why *Tribune II* based dismissal on principles not addressed by the Supreme Court.

Merit Management did not deal with whether the defendants were subsumed within the definition of a "financial institution" as defined in Section 101(22)(A). The *Tribune II* court ruled on the issue, and Judge Grossman naturally followed the Second Circuit.

A "financial institution" in Section 101(22)(A) is defined as a bank or "trust company, . . . and when any such . . . entity is acting as agent . . . for a customer . . . in connection with a securities contract . . . such customer." In the opinion of the Second Circuit, a customer of a financial institution itself becomes a "financial institution" if the financial institution is acting as the customer's agent. That's what Judge Grossman held, invoking *Tribune II* as binding authority.

Ruling that the defendants were financial institutions was not enough by itself to invoke the safe harbor, because the liquidating trustee argued that his suit was based on state law, not Section 548. However, the *Tribune* decisions foreclosed the argument because the Second Circuit held that Section 546(e) preempts state law as to companies that end up in bankruptcy.

Judge Grossman held that federal preemption applies as much to fraudulent transfers with "actual intent" as it does to constructively fraudulent transfers. He therefore dismissed the trustee's complaint because the Section 546(e) safe harbor made the defendants immune.

Judge Grossman's opinion covered several other topics that arise in leveraged buyout and refinancing litigation. He dealt with statutes of limitations and a Delaware statute of repose, the pleading standard when defrauded institutions were sophisticated creditors, and whether a "critical mass" of directors must have acted with fraudulent intent. On those other issues, Judge Grossman upheld the trustee's pleading, but to no avail, because the defendants drew a get-out-of-jail-free card called Section 546(e).

To read's ABI's reports on *Merit Management* and *Tribune II*, click here and here.

Observations

Even with *Merit Management* on the books, there may never be liability for receipt of a fraudulent transfer clothed as a leveraged buyout or leveraged refinancing.

The definition of "financial institution" in Section 101(22)(A) suggests that no one will ever be held liable unless those who structured the transaction were asleep at the switch.

A financial institution is defined a "commercial . . . bank , . . . and when any [bank] is acting as agent . . . for a customer . . . in connection with a securities contract . . . such customer." Translated into plain English, as the Second Circuit said, a customer of a financial institution itself becomes a "financial institution" if the financial institution is acting as the customer's agent in a leveraged transaction.

Consequently, the nonbank customer (*i.e.*, recipient of a fraudulent transfer) magically becomes a financial institution and may then raise Section 546(e) as a complete defense to fraudulent transfer liability.

Collier recognizes the shortcomings in *Merit Management* in light of the definition of "financial institution." The treatise says:

> On its face, *Merit Management* appears to narrow meaningfully the application of section 546(e) to distributions to nonfinancial institution shareholders in connection with leveraged buyouts and similar transactions. However, a couple of factors may yet affect the significance of the result. First, the parties did not argue that the initial transferor or ultimate transferee itself qualified as a "financial institution" under the Code by virtue of being a "customer" of a financial institution that acted as its agent or custodian in connection with a securities contract — **a powerful argument that may allow future defendant transferees to avail themselves of section 546(e)'s safe harbor protections notwithstanding the *Merit Management* decision**. Second, the market may adapt to obtain the benefit of the section 546(e) safe harbor notwithstanding the *Merit Management* holding. For example, prior to receiving distributions on their stock in connection with LBOs, larger stockholders may (a) sell their stock to financial institutions that are eligible for the section 546(e) safe harbor or (b) move their stock into custodial accounts with financial institutions and thereby be treated as financial institutions by virtue of the definition of "financial institution" in section 101(22)(A).

5 *Collier on Bankruptcy* ¶ 555.06 (16th rev. ed. 2020). [Citations omitted; emphasis added.]

This writer questions whether Congress intended for all recipients of fraudulent transfers in LOBs to be immune from liability. Such broad exculpation goes far beyond the need for protecting the securities markets, but that's what the statutory language says.

The definition in Section 101(22)(A) applies to more than Section 546(e). The definition plays its most important role in provisions like Section 555 and 556, which allow immediate liquidation of securities contracts after a bankruptcy filing. In those circumstances, it makes sense for a nonbank to have the status of a bank or broker, otherwise there would be gaps in the right to liquidate.

Although the broad definition makes sense in the context of Sections 555 and 556, the same cannot be said for Section 546(e). This writer submits that Congress should give "financial institution" a separate and more narrow definition for use with Section 546(e). Otherwise, the Bankruptcy Code will be read as explicitly condoning (if not promoting) fraudulent transfers.

The opinion is *Holliday v. K Road Power Management LLC (In re Boston Generating LLC)*, 12-01879 (Bankr. S.D.N.Y. June 18, 2020).

In a fraudulent transfer of a contract claim, a subsequent recipient of cash proceeds from the claim has no liability under Section 550(a)(2), according to the Tenth Circuit.

Tenth Circuit Protects Subsequent Recipients of Fraudulent Transfer with a New Defense

The Tenth Circuit handed down an opinion on July 10 that will be cited for the controversial proposition that a subsequent recipient of proceeds from fraudulently transferred property cannot be held liable under Section 550(a)(2), even if the subsequent transferee was aware of the fraud.

The Denver-based appeals court reasoned that a trustee cannot recover cash proceeds from fraudulently transferred property because the proceeds were not the "property transferred" under Section 550(a). The appeals court cited no caselaw authority for its interpretation of the statute.

The initial transferee took a contract claim in a fraudulent transfer. The initial transferee converted the contract claim to cash and transferred the cash to a subsequent transferee. The Tenth Circuit held that the subsequent transferee had not received a "transfer" because the property that it received was cash, not the contract claim.

The Complex Facts

In her 17-page opinion for the appeals court, Circuit Judge Carolyn B. McHugh needed nine pages to lay out the highly complex facts. We hope the following summary is a fair representation.

A company had rights to develop a wind-power project. The builder was obligated to pay the developer a fee and the developer's costs when the project was completed and sold. The developer became insolvent but did not file bankruptcy. Instead, the insolvent developer transferred its rights as developer to a new company that we will refer to as the transferee. As part of the transfer, the transferee received the developer's rights to be paid the developer's costs and fees.

When the project was completed and sold, the builder paid the transferee some $5 million, but the transferee retained counsel to sue, claiming more was owed on account of the developer's costs and fees. Eventually, a federal court in Pennsylvania entered a $9 million judgment against the builder and in favor of the transferee.

After receiving the $9 million, the transferee paid two law firms a total of about $2 million in fees for prosecuting the lawsuit against the builder.

Along the way, the original, insolvent developer filed a chapter 7 petition. Later, the chapter 7 trustee sued the transferee for receipt of a fraudulent transfer, namely, the right to be paid when the project was sold. The trustee ultimately obtained a $10.5 million consent judgment against the transferee. The trustee was unable to collect anything from the transferee on account of the fraudulent transfer judgment.

So, the trustee sued the two law firms for $2 million as subsequent recipients of the fraudulent transfer under Section 550(a). The bankruptcy court denied the law firms' motion to dismiss, but the Tenth Circuit granted permission for a direct, interlocutory appeal.

Proceeds of the Fraudulent Transfer Weren't Recoverable

Judge McHugh reversed, directing the bankruptcy court to dismiss the suit against the two firms. She held that the firms were not transferees of the fraudulently transferred property (the developer's rights to payment) and therefore had no liability under Section 550(a).

Judge McHugh based her decision on the plain language of Section 550(a). She said that the "firms are not subsequent transferees because they never received the property transferred, *i.e.*, the contractual right to the . . . sales proceeds." She said there was no evidence that the transferee transferred the right to receive sale proceeds to the two firms. In other words, "neither firm is a transferee of the property that was set aside as fraudulently transferred."

The trustee argued, however, that Section 550(a) permits recovery of "the transferred property, or if the court so orders, the value of such property." In other words, the trustee was contending that he had the right to recover proceeds from the fraudulent transfer as the "value" of the fraudulently transferred property.

Judge McHugh rejected the argument. Even if there had been an order to recover the value of the transferred property, she said the trustee could not recover under Section 550 because "the firms are not transferees" of the property that was fraudulently transferred — that is, the contract right to receive payments on sale.

Judge McHugh also rejected the trustee's contention that the payments to the firms were "proceeds" of estate property under Section 541(a)(6). Even if the payments were proceeds of estate property, she said that nothing in Section 541(a)(6) "expands the trustee's powers under § 550 to recover from persons who are not transferees."

With regard to the trustee's argument under Section 541, Judge McHugh said that if Congress had intended "to provide the trustee with power to trace proceeds . . . , it could have [written Section 550 to say] so."

The Tenth Circuit appears to have held: If a debtor fraudulently transfers a contract claim, and if the initial transferee converts the contract claim to cash, a subsequent transferee of the cash did not receive a transfer of the fraudulently transferred property (the contract claim) and therefore cannot be held liable under Section 550(a).

Observations

Respectfully, the Tenth Circuit gutted fraudulent transfer law and blessed a process allowing a fraudster to immunize proceeds from recovery. Take the following example.

A fraudster fraudulently transfers real property to the initial transferee. The initial transferee sells the property for cash and transfers the cash to a subsequent transferee. Under the Tenth Circuit's holding, the subsequent transferee has a complete defense, even if the subsequent transferee was aware of the initial fraud. If the initial transferee is judgment-proof, creditors would have no recovery.

The holding is a startling development in fraudulent transfer law, and particularly so because the circuit only cited the statute for authority. When a court is issuing a significant opinion with profound implications for fraudulent transfer law, one ordinarily would expect the court to cite and discuss authority from caselaw and treatises.

Granted, the Tenth Circuit reached a result that might seem equitable to some. However, fraudulent transfer law can bring results that don't seem equitable to everyone, particularly when dealing with subsequent recipients unaware of the fraud.

The two law firms generated value by converting a contract claim to a judgment and a monetary recovery. As subsequent recipients, the two firms might therefore have had "good faith" defenses under Sections 550(b)(2) and (e).

Still, the law firms might not have qualified for good faith defenses had they been aware of the manner in which the transferee came into possession of the contract claim.

Scholarly Commentary

ABI received commentary on the opinion from two law professors: Bruce A. Markell, Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law, and Jack F. Williams, Professor of Law at the Georgia State Univ. College of Law.

Commentary from Prof. Markell:

"The opinion will cause great mischief," Prof. Markell said. He told ABI that the opinion "is so wrong that I don't know exactly where to begin.

"It ignores that, under the avoidance statutes such as Sections 548 and 547, the phrase 'an interest of the debtor in property' has generally been held to be the equivalent of 'property of the estate.' *See Begier v. IRS*, 496 U.S. 53, 59 (1990) ("Although not defined by the Code, 'property of the debtor' is best understood to mean property that would have been part of the estate had it not been transferred.").

"Section 550 just deals with property subject to avoidance under Section 548, so 'property transferred' under 550 would be the 'property of the debtor' subject to avoidance under Section 548, and thus would include the proceeds concept under Section 541(a)(6), therefore giving the estate an interest in proceeds.

"The court's analysis seems clouded by the intangible nature of the property involved. Yes, a payment obligation is discharged and does not exist after payment. But the payment persists, and is clearly subject to the 'property or value' language in Section 550.

"In short, I had always thought that, if a proceeds concept wasn't imported from the various avoidance sections (the 'property of the debtor' argument above), then the 'or value' language allowed courts to pursue proceeds.

"Otherwise, by the court's logic, even the initial transferee could claim it no longer held the intangible property, and thus would not have to disgorge. A transferee might say with a straight face, 'I don't have the property you seek,' but they can't say, 'I don't have the value of the property you seek.'

"Making distinctions between those two statements is a short path to chaos."

Commentary from Prof. Williams:

Prof. Williams told ABI that the opinion is "quite questionable." He said that the "point about no citation of authority is a good one but expected. Because there isn't any."

Prof. Williams believes the opinion "is an unprecedented departure from fraudulent transfer law and from its cousin, restitution. It also does not square with the statute.

"Section 548's focus, for these purposes, is on an 'interest in property' and not the 'thing' itself. Equity has long recognized, and so too fraudulent transfer law, that interests in property can carry forward even if the underlying property changes its character.

"Think of the ability to trace identifiable proceeds of property for purposes of the imposition of an equitable lien or constructive trust. But it is the court's treatment of section 541 that is most troubling.

"Section 541 is silent on the meaning of 'property'; rather, it speaks to property 'of the estate.' Sections 541(a)(3), (a)(6) and (a)(7) focus on when property becomes something more, when it transforms from property to property of the estate.

"I am reminded of Twains' observation that the difference between the 'right word' and the 'almost right word' is similar to the difference between lightning and a lightning bug.

"Although the Supreme Court reminds us, in *Chicago Bd. of Trade v. Johnson*, 264 U.S. 1 (1924), that property under bankruptcy law is a federal question, we do not hesitate to consult state law for guidance. But just because it is property does not make it property of the estate. This is especially the case where the definition of property of the estate contains that temporal element — that is, all of the debtor's legal or equitable interest in property at the time of the petition date. Section 541(a)(1).

"So now to how this plays out. Once a debtor transfers property prepetition, it is no longer property of the estate. However, at the time of the prepetition transfer, it is a transfer of an interest in property (including the right to convert property to cash and grant good title). Section 550 allows the recovery of the property transferred ***or the value of property transferred*** that is subject to avoidance under section 548 from the initial transferee, the immediate transferee and any mediate transferee.

"Each transferee has its own potential defense, some of which appear to be applicable in the case, including good faith under Section 550(b). The court's holding and analysis simply does not square with the statutory regime or the language of Sections 541 and 550.

"Now the 'Choctaw' Test: How would this holding apply to a run-of-the mill case? If the result is silly, try again. A transfers Greenacre to A's brother as a gift while A is insolvent. A's brother sells Greenacre to Joe, who takes it in good faith and for fair value. A's brother then transfers the cash proceeds of the sale to A's daughter. How would the Tenth Circuit resolve this issue if A then files a bankruptcy petition and his trustee commences a section 548/550 action against A's brother, Joe and A's daughter? Assume A's brother is hopelessly insolvent. The trustee avoids the transfer to A's brother; insolvents can't make gifts. But A's brother no longer has the property or the proceeds and is insolvent — so no luck. Worse, the property is in the hands of a protected BFP, so no recovery of the property here, either. That leaves A's daughter. But she does not have the 'property transferred,' so she is not subject to Section 550, according to the Tenth Circuit. And she gets to keep the cash. That is a silly result. Silly amplifies the fallacy in the Tenth Circuit's opinion. This is, and should be, a 'good faith' case."

The opinion is *Rajala v. Spencer Fane LLP (In re Generation Resources Holding Co.)*, 19-3226 (10th Cir. July 10, 2020); rehearing an rehearing *en banc* denied Aug. 24, 2020.

Proceeds from fraudulently transferred property can be recovered from subsequent transferees, Judge Rodriguez says, differing with the Tenth Circuit's Generation Resources opinion.

Houston Judge Rejects Tenth Circuit Opinion Immunizing Subsequent Transferees

A bankruptcy judge in Houston rejected a new defense created this summer by the Tenth Circuit to absolve subsequent transferees from liability for receiving proceeds from a fraudulent transfer, even if they knew fraud was afoot.

In the Tenth Circuit case, the initial transferee took a contract claim in a fraudulent transfer and converted the contract claim into cash. The initial transferee then transferred cash to subsequent transferees whom the trustee sued.

Interpreting Section 550(a) in July, the Denver-based appeals court held that the trustee could not recover cash proceeds from the fraudulently transferred contract claim because the cash proceeds were not the contract claim that was initially transferred. The appeals court cited no caselaw or scholarly authority for its interpretation of the statute. *Rajala v. Spencer Fane LLP (In re Generation Resources Holding Co.)*, 964 F.3d 958 (10th Cir. July 10, 2020); rehearing and rehearing *en banc* denied Aug. 24, 2020. To read ABI's report, click here.

Houston Case Similar to *Generation Resources*

The facts before Bankruptcy Judge Eduardo V. Rodriguez were functionally similar in terms of applying the Tenth Circuit's defense.

A software development company was in financial distress. The chief executive officer wanted to sell the company, but the sale would not generate much for him because he owned only 3 percent of the stock.

To increase his recovery from selling the company, the CEO secretly arranged for the company to issue convertible preferred stock to him, which he in turn sold for $15 million. Were it not for the preferred stock, the $15 million would have gone to the company, not to the CEO. In return for the stock, the CEO claimed that he gave adequate consideration by agreeing to take on the additional role of chairman.

The CEO transferred about $5 million of the proceeds to those whom we shall refer to as subsequent transferees.

Creditors filed an involuntary petition against the software developer, and a chapter 7 trustee was appointed. Under the Texas Uniform Fraudulent Transfer Act and Sections 544 and 550(a)(2), the trustee sued the subsequent transferees who had received the $5 million.

Notably, the CEO was both indicted by the Justice Department and sued by the Securities and Exchange Commission, but he died not long after bankruptcy.

The defendants filed motions to dismiss raising a plethora of arguments, which Judge Rodriguez denied on October 22. We shall address a pair of important rulings from his 54-page opinion.

The *Generation Resources* Defense

Citing *Generation Resources*, the defendants contended that they were not subsequent transferees and therefore could not be sued, because they received proceeds from the preferred stock, not the stock itself. If Congress had intended for trustees to recover proceeds, it could have written Section 550 to say so, they argued.

Judge Rodriguez observed that *Generation Resources* "is the only circuit-level case directly on point." He went on to say that the issue of first impression in the Fifth Circuit raised "novel legal arguments that are undeveloped in the case law." Outside the Fifth Circuit, case law "is practically nonexistent," he said.

Section 550(a)(2) permits recovery of "the transferred property, or if the court so orders, the value of such property, from . . . any immediate or mediate transferee of such initial transferee." Judge Rodriguez said he was therefore tasked with deciding whether the defendants were immediate or mediate transferees.

Before launching into his own analysis, Judge Rodriguez cited to articles criticizing *Generation Resources*. Bruce A. Markell, the Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law, said the Tenth Circuit "got it wrong." Bruce A. Markell, *Where Does the Flame Go When the Candle Is Blown Out, or Why Can't Courts Grasp the Concept of Intangibles?*, 40 Bankr. L. Letter 1 (2020).

Judge Rodriguez also quoted ABI's *Rochelle's Daily Wire* from August 14, where the writer said that the "Tenth Circuit gutted fraudulent transfer law and blessed a process allowing a fraudster to immunize proceeds from recovery."

To divine the result, Judge Rodriguez analyzed the statutory language. He conceded that the most natural reading of "transferred property" would allow the trustee to recover the preferred stock. "While this reading makes sense," Judge Rodriguez said, "it does not give enough consideration to the language used in subsections (a)(1) and (a)(2)" of Section 550.

For Judge Rodriguez, the significant phrase is "any immediate or mediate transferee *of such initial transferee*." [Emphasis in original.] The statute, he said, does not say "any immediate or mediate transferee *of the property transferred*." [Emphasis in original.]

The initial transferee must have received a transfer of the property, but "that same restriction is not placed on immediate and mediate transferees," Judge Rodriguez said.

Judge Rodriguez noted that Section 550(b) gives a complete defense to a subsequent transferee who takes for value and in good faith. If *Generation Resources* were correct, a subsequent transferee could take proceeds with knowledge of the fraud and still escape liability.

"That result," Judge Rodriguez said, "fails to consider Section 550(a) in context. The complete defense set forth in Section 550(b) adequately protects those who were not privy to the initial transferee's wrongdoing."

Like the commentators who criticized *Generation Resources*, Judge Rodriguez said that the Tenth Circuit defense would create "perverse incentives" for the initial transferee to liquidate the property to make the proceeds "unrecoverable."

Judge Rodriguez denied the motion to dismiss under *Generation Resources*, saying it does not "square with the Bankruptcy Code's policy of maximizing the estate for all creditors."

"Judge Rodriguez's meticulous opinion carefully dissects the erroneous *Generation Resources* opinion, exposing it to the scorn it deserves." Prof. Markell told ABI in an email. He added that "Judge Rodriguez's opinion is not only right on the law, it is right on the policy."

No Need to Sue the Initial Transferee

The defendants argued that the trustee could not sue them until he "avoided" the initial transfer to the CEO. They based their contention on the language in Section 550(a) that allows recovery "to the extent that a transfer is avoided," not "avoidable."

Judge Rodriguez quoted the *Collier* treatise for saying that a trustee may recover from a subsequent transferee "without suing the initial transferee." Among lower courts in the Fifth Circuit, however, the authorities "diverge," the judge said.

Judge Rodriguez decided that Section 550 does not require suing the CEO or his estate before recovering from the subsequent transferees. Rather, the phrase "to the extent that a transfer is avoided" only limits the trustee's recovery to "the amount of a transfer that could be statutorily avoided."

"Moreover," Judge Rodriguez said, "neither § 550 nor § 544 require the transfer to be avoided as to the initial transferee before a trustee can seek recovery from immediate or mediate transferees."

Once the trustee demonstrates the existence of an avoidable transfer, Judge Rodriguez said that Section 550 "permits recovery from the initial transferee and any immediate or mediate transferees. There is nothing in Section 550 requiring a trustee to seek an avoidance action specifically against the initial transferee before recovery can be realized against the other transferees."

Judge Rodriguez denied the defendants' blunderbuss motion to dismiss. He did require the trustee under Section 544(b) to amend the complaint by specifically identifying the creditors who were in existence and could assert the fraudulent transfer claim under Texas law.

The opinion is *Cage v. Davis (In re Giant Gray Inc.)*, 20-3127, 2020 BL 410247, 2020 Bankr Lexis 2980 (Bankr. S.D. Tex. Oct. 22, 2020).

Receiver barred from bringing aiding and abetting claims if the company was dominated by fraudsters.

Routine Withdrawals from a Bank Account Aren't 'Transfers,' Eleventh Circuit Says

Routine deposits and withdrawals from a bank account are not "transfers" and thus cannot form the basis for a fraudulent transfer suit against the bank, according to the Eleventh Circuit.

And even if the bank was aware of fraud, the appeals court ruled that a receiver cannot successfully mount aiding and abetting claims against the bank if the company was completely dominated by fraudsters.

The Ponzi Scheme

A corporation was a thoroughgoing Ponzi scheme. The state court appointed a receiver. Alleging that the corporation's primary bank was aware of fraud, the receiver sued the bank in state court for receipt of fraudulent transfers under Florida's version of the Uniform Fraudulent Transfer Act, or FUFTA.

The receiver also mounted tort claims against the bank for aiding and abetting breach of fiduciary duty, conversion and fraud.

The district court granted the bank's motion to dismiss, and the receiver appealed.

The Eleventh Circuit upheld dismissal in a June 1 opinion by Circuit Judge Gerald B. Tjoflat, a federal judge for almost 50 years.

The Fraudulent Transfer Claims

To construct a claim under FUFTA, there must be a "transfer." Although the word is defined broadly, Judge Tjoflat explained that the plaintiff must "show that the debtor either disposed of his asset or relinquished some interest in that asset . . . . As long as the debtor relinquishes some interest in or control over the asset a FUFTA transfer has occurred, even if he remains the technical owner of the asset." [Citations omitted.]

As transfers, the complaint identified deposits into the bank account, withdrawals from the account, and intercompany transfers for one account to another. The trustee argued that the

activities amounted to transfers under FUFTA because the bank took title to the money and owed a debt to the company in return.

Not so, Judge Tjoflat said. "We disagree that a routine bank deposit constitutes a transfer to the bank within the meaning of the FUFTA." For a transfer, he said, "the relevant inquiry is not one of ownership or title but of control."

Although the bank replaced money with a debt, Judge Tjoflat said that the company never relinquished its interest or control by maintaining full control over the funds. Thus, he held that the company "did not transfer that money to [the bank] within the meaning of the FUFTA."

Judge Tjoflat upheld dismissal of the FUFTA claims without reaching the question of whether the bank had a defense as a "mere conduit." He did not reach the issue because "mere conduit" only comes into play if there was a transfer in the first place.

The Tort Claims

The appeals court had the parties submit supplemental briefs on the question of whether the misdeeds of the fraudsters were imputed to the receiver. We bet you're guessing that Judge Tjoflat would uphold dismissal of the tort claims under the doctrine of *in pari delicto*, which means in equal fault. Under English common law, courts invoked the doctrine to prevent the court from aiding one fraudster to sue another.

Nope, *in pari delicto* was not the basis for dismissal. There were other fatal defects, relating to claims that a receiver may or may not bring.

A receiver may not assert claims belonging to creditors. "Rather, he is limited to bringing only those actions previously owned by the party in receivership," Judge Tjoflat said.

The question then becomes whether the company could have brought aiding and abetting claims and whether the Ponzi schemers' fraud was therefore imputed to the receiver.

Judge Tjoflat turned to an intermediate Florida appellate court for guidance. The state court said that a receiver does not always inherit the sins of the company. For complicated reasons that amount to a convenient legal faction, courts hold that a receiver in a Ponzi scheme has standing to sue under FUFTA.

"On the other hand," Judge Tjoflat said, there "are common law tort claims against third parties to recover damages for the fraud perpetrated by the corporation's own insiders." In those cases, he said, the receiver has no standing unless the company had "at least one honest member of the board of directors or an innocent stockholder." If someone was honest, then there was injury to the corporation that a receiver could seek to remedy.

In his complaint, the receiver alleged that the fraudsters had complete control and wholly dominated the company. Consequently, Judge Tjoflat said, the "Receivership Entities cannot be said to have suffered any injury from the Ponzi scheme that the Entities themselves perpetrated."

In a case like the one on appeal, Judge Tjoflat said that the aiding and abetting claims "belong to the investors who suffered losses from this Ponzi scheme, not the Receivership Entities."

Making a distinction that did not alter the outcome, Judge Tjoflat said that the receiver's "ability to pursue these claims is barred not by the doctrine of *in pari delicto*, but by the fact that the Receivership Entities were controlled exclusively by persons engaging in and benefitting from the Ponzi scheme, and so the Receivership Entities were not injured by that scheme."

In short, the Eleventh Circuit upheld dismissal of the aiding and abetting tort claims based on convenient legal fictions that bar a receiver from mounting claims for the benefit of all creditors.

Observations

If we live long enough, Congress and the states will adopt laws permitting receivers and bankruptcy trustees to sue wrongdoers without facing defenses like *in pari delicto*. Or, perhaps a brave appellate court will free courts in the 21st century from the shackles of English common law, which, in the view of this writer, has been misapplied to receivers and bankruptcy trustees.

Imposing doctrines like *in pari delicto* on bankruptcy trustees overlooks an important reform in the Bankruptcy Code. Under the prior Bankruptcy Act, trustees took title to estate property. It was also said that trustees stepped into the shoes of the debtors. As a result, there was some theoretical basis for making trustees subject to *in pari delicto*.

Instead, the Bankruptcy Code creates an estate (Section 541(a)), and the trustee administers the estate. The trustee neither takes title to estate assets nor steps into the shoes of the debtor. As a result, there is a basis in the statute to recognize that *in pari delicto* does not apply to bankruptcy trustees.

The opinion is *Isiah v. JPMorgan Chase Bank NA*, 17-15585 (11th Cir. June 1, 2020).

Executory Contracts & Leases

For the Eleventh Circuit, scheduling the unsecured claim resulted in automatic rejection even though the contract was not scheduled as executory.

Executory Contract Was Deemed Rejected Even Though Not Scheduled as Executory

Even though the debtor had not listed a contract among her executory contracts, all of the claims associated with the contract were discharged because the debtor had scheduled the counterparty as a creditor, the Eleventh Circuit ruled.

The debtor had a contract for satellite television service. Before bankruptcy, she took advantage of a provision in the contract allowing her to "pause" the contract for up to nine months. During the pause, her monthly payment would decline to $5 a month, but she wouldn't have television service. The number of months the contract was on "pause" would be added to the term of the contract once the "pause" ended.

In chapter 7, the debtor scheduled the satellite provider as having an unsecured claim for about $850, but she did not list the contract on her schedule of executory contracts. The trustee neither assumed nor rejected the contract. The parties agreed that the agreement was an executory contract.

After discharge, the satellite provider contacted the debtor numerous times attempting to collect the $5-per-month "pause" fee. The debtor sued in federal district court, claiming that the attempted collection of a discharged debt violated both the Florida Consumer Collection Practices Act and the Telephone Consumer Practices Act.

The district court dismissed the claims under both statutes. The district court reasoned that the contract was not rejected because it was not scheduled as executory. The contract not having been rejected, the district court believed that "pause" charges accrued after filing were not discharged.

Sitting by designation, Senior District Judge C. Ashley Royal of Macon, Ga., reversed in an opinion on May 1.

Judge Royal held that the failure to schedule the executory contract did "not prevent its deemed rejection" under Section 365(d)(1). That section provides that a contract not assumed or rejected within 60 days of a chapter 7 order for relief is deemed rejected.

To reach this conclusion, Judge Royal noted that the satellite provider was listed as an unsecured creditor and "clearly" had notice of the bankruptcy. Also, there was no evidence that the debtor intentionally concealed the contract.

Given those facts, Judge Royal found that the contract "was deemed rejected pursuant to Section 365(d)(1)." In turn, rejection resulted in a prepetition breach of contract under Section 365(g), giving the provider a prepetition breach of contract claim for the "pause" debt.

Having found that the "pause" debt was discharged, Judge Royal reinstated the debtor's claim under the FCCPA but upheld dismissal of the TCPA claim.

In her concurring opinion, Circuit Judge Britt C. Grant said in substance that the appeals court might have also reinstated the TCPA claim had the debtor not waived a pivotal argument on appeal. Therefore, the circuit's affirmance of dismissal of the TCPA claim should have little precedential value.

The opinion is *Medley v. Dish Network LLC*, 18-13841 (11th Cir. May 1, 2020).

Insurance companies must nail down the treatment of performance bonds before plan confirmation.

Surety Bonds Aren't Executory Contracts and Can't Be Assumed Even if They Are

On a topic where there is surprisingly little law, Bankruptcy Judge Douglas D. Dodd of Baton Rouge, La., wrote an opinion that contains everything you need to know about the status of surety bonds in chapter 11.

He held that (1) a surety bond is not an executory contract; (2) even if it were an executory contract, it is a financial accommodation that cannot be assumed; (3) the bonding company may not consent to assumption; and (4) if no claim has been made on the bond, the unsecured claim is disallowed for being contingent and unliquidated.

Judge Dodd's September 22 opinion is a teaching moment for counsel representing bonding companies. It tells them to nail down the treatment of bonds in a chapter 11 plan and never assume a bond will ride through bankruptcy unaffected.

The E&P Bonds

The debtor was engaged in oil and gas exploration and production. Before bankruptcy, the debtor had acquired four performance bonds covering the debtor's obligations to the state for environmental liabilities and for plugging and abandoning wells.

The insurer was liable for a maximum of about $10.6 million on the bonds. 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.

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

The bonding company may have been lulled into complacency throughout the chapter 11 case.

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, and the plan said that executory contracts were deemed to be assumed unless they were listed for rejection. The bonds were not on the list of rejected executory contracts.

Apart from filing a claim, the bonding company did not appear in the bankruptcy case until six months after confirmation, when the insurer demanded extra collateral for the bonds. The debtor responded by alleging that the demand for collateral was in violation of the discharge injunction, because the bonds were not and could not be assumed.

The Bonding Company Loses (Almost) Every Argument

Right down the line, Judge Dodd sided with the debtor. First, he held that the bonds were not executory contracts.

Applying the so-called Countryman test, Judge Dodd said that the insurer had performed its only obligation to the debtor before bankruptcy by posting the bonds with the state. The insurer's only continuing obligation was to the state, to make good on the bonds if claims were made. The bonds were not executory contracts because the insurer had no continuing obligations to the debtor.

Even if the bonds were executory contracts, they could not be assumed under Section 365(c)(2). The section bars assumption of a "contract to make a loan, or extend other debt financing or financial accommodations."

Although the Fifth Circuit has not ruled, Judge Dodd said that a "majority of courts" have held that surety bonds are financial accommodations. Even if the bonds were executory contracts, he held, a bond "is a financial accommodation that cannot be assumed under Section 565(c)(2)."

The insurer argued that a nonassumable contract could still be assumed with the bonding company's consent.

Judge Dodd disagreed. Even if there were evidence of consent, he held, the bonds still could not be assumed because consent is not an exception to Section 365(c)(2) like it is to Section 365(c)(1)(B).

Not finished drubbing the bonding company, the debtor argued that the unsecured claim was disallowed under Section 502(e)(1)(B). Judge Dodd agreed.

The section provides that "the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on . . . the claim of a creditor, to the extent that . . . such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution."

Judge Dodd quoted the *Collier* treatise for saying that the section applies "to a debt owed by the debtor to a creditor which has been guaranteed by a third party." 4 *Collier on Bankruptcy* ¶ 502.06[d] (16th ed. 2020). He ruled that the unsecured claim met all the criteria.

The unsecured claim was entirely contingent because no claims had been made against the bonds; the insurer's claim was for contribution or reimbursement, and the insurer and the debtor would be liable for the same claim if one were made by the state.

Judge Dodd therefore ruled that the unsecured claim "was disallowed upon plan confirmation."

The bonding company was off the hook for violating the discharge injunction, in light of *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1799 (June 3, 2019), where the Supreme Court held that a court "may impose civil contempt sanctions [for violating the discharge injunction] when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order."

Judge Dodd decided that the insurer could not be held in contempt because its "uncertainty about its treatment was reasonable."

The opinion is *In re Flacon V LLC*, 19-10547 (Bankr. M.D. La. Sept. 22, 2020).

Majority on Ninth Circuit panel believe that having previously extended a deadline allowed the invocation of "excusable neglect" to extend the deadline again after it expired.

Split Ninth Circuit Permits Extending a Statutory Deadline After It Expires

A panel of the Ninth Circuit disagreed about the ability of a bankruptcy court to extend the deadline for assuming an executory contract after the deadline expired under Section 365(d).

In the opinion of the majority, the bankruptcy court had power to extend the assumption deadline because the trustee demonstrated "excusable neglect" under Bankruptcy Rule 9006(b)(1), when the court had previously granted an extension before the original expiration of the deadline.

The majority reasoned that the deadline was no longer one imposed by statute when the court had previously granted an extension, thus giving the bankruptcy court power to modify its own order.

Marathon Litigation

The case involved long-fought litigation that had been to the Ninth Circuit once before. *See In re Point Center Financial Inc.*, 890 F.3d 1188 (9th Cir. 2018). There, the appeals court took sides in an existing circuit split by holding that attendance or objection in bankruptcy court are not prerequisites to being an aggrieved person with standing to appeal. To read ABI's report, click here.

The case went down and back up again on different questions, the most prominent being the power to extend the assumption deadline after it had expired.

Originally, the chapter 7 trustee had obtained an extension of the assumption deadline by seeking an enlargement before the 60-day deadline had run out under Section 365(d)(1). The trustee had not sought a further extension based on a former corporate officer's statement that the management agreement in question had no value.

It turned out there was value because the property could be sold. Therefore, the trustee filed a motion for an extension more than two years after the extended deadline had elapsed. The trustee claimed there was "excusable neglect" under Rule 9006(b)(1) because he had been misled by the former corporate officer.

The bankruptcy court granted the extension and authorized assumption of the executory contract. The district court affirmed, prompting the appeal to the Ninth Circuit.

The Majority Opinion

Sitting by designation, Chief District Judge Algernon L. Marbley from the Southern District of Ohio wrote the majority opinion for himself and Circuit Judge Sandra S. Ikuta. He first ruled that the appellants had standing to appeal and that the bankruptcy court had jurisdiction under 28 U.S.C. § 1334(b) and (e).

Judge Marbley then turned to the question of whether the bankruptcy court had power to extend its own deadline for "excusable neglect." Even though the deadline had expired, he decided that the retroactive extension granted by the bankruptcy court fell within the "plain language" of Rule 9006(b) because the trustee's failure to act was the result of excusable neglect.

The question was an issue of first impression in the Ninth Circuit, but Judge Marbley agreed with *In re Chira*, 343 B.R. 361, 370–71 (Bankr. S.D. Fla. 2006), *aff'd*, *In re Chira*, 367 B.R. 888 (S.D. Fla. 2007).

Like *Chira*, Judge Marbley found power to extend the deadline retroactively for excusable neglect because the bankruptcy court had "taken control" of the deadline once before by granting an extension before the original deadline had expired.

The Dissent

Circuit Judge Morgan Christen dissented in part but concurred in the result on different grounds.

Judge Christen agreed that the appellants had standing to appeal and that the bankruptcy court had jurisdiction under Section 1334(b), but she disagreed about the power to extend the deadline under Rule 9006(b)(1).

Judge Christen described the rule as allowing bankruptcy courts "to extend their own deadlines." She said she was "not persuaded that the bankruptcy court had the authority to retroactively reopen the period Congress specified for accepting an executory contract, and because it appears the majority's reasoning would allow the bankruptcy court to reopen and extend any deadline without limit."

If the deadline had been extended before expiration, Judge Christen said the "parties are not disadvantaged." On the other hand, she said, "the majority's new rule will leave parties guessing about whether expired deadlines will be revived years after the fact."

The majority had not reached the question of equitable mootness because they had affirmed on the merits. Finding the case to be "an easy fit for the doctrine of equitable mootness," Judge Christen said she would affirm "on that basis alone."

The opinion is *Harkey v. Grobstein (In re Point Center Financial Inc.)*, 18-56398 (9th Cir. April 29, 2020).

Jurisdiction & Power

Is the Barton doctrine based on a lack of subject matter jurisdiction, or is it a prudential rule?

Eleventh Circuit Finds Discretion to Disregard the *Barton* Doctrine

The Eleventh Circuit allows a suit against a professional who had been retained in a dismissed bankruptcy case if there is prudential justification for an exception to the so-called *Barton* doctrine.

This writer understands the October 20 opinion to mean that nonbankruptcy courts have discretion to disregard *Barton*. The Eleventh Circuit may be saying that *Barton* is not founded on a lack of subject matter jurisdiction.

The Suit Against Debtor's Counsel

A law firm represented the corporate debtor in a chapter 11 case. The debtor's counsel repeatedly represented to special counsel that special counsel had been retained by the bankruptcy court in a "bench order." The debtor's counsel even made the same representation to the bankruptcy court. In fact, there was no order, even though special counsel was paid by the debtor.

Eventually, the truth came out, and the bankruptcy court directed special counsel to repay the fees it had been paid. Later, the chapter 11 case was dismissed.

After dismissal, special counsel sued the debtor's counsel in federal district court, raising claims of negligent and intentional misrepresentation. The district court found personal jurisdiction over the debtor's counsel but dismissed the case under the *Barton* doctrine for lack of subject matter jurisdiction.

The law firms filed cross-appeals. Special counsel argued that *Barton* cannot apply when the bankruptcy case has been dismissed.

The Genesis of *Barton*

Writing for the appeals court, Circuit Judge Beverly B. Martin explained that the doctrine was first pronounced by the Supreme Court in 1881. *Barton v. Barbour*, 104 U.S. 126 (1881). Originally, *Barton* amounted to 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.

Judge Martin explained why courts have understood *Barton* to be based on a lack of subject matter jurisdiction.

The doctrine comes from the idea that the bankruptcy court has exclusive *in rem* jurisdiction over the bankrupt estate. By suing a court-retained professional outside of bankruptcy court, the creditor would be interfering with the bankruptcy court's exclusive jurisdiction because the suit could have a "conceivable effect" on the estate.

In the case on appeal, Judge Martin said, both sides agreed there could be no "conceivable effect" on the estate because the bankruptcy case had been dismissed. Therefore, she said, the bankruptcy court did not have jurisdiction over the lawsuit, and special counsel was "not required to obtain leave from that court before filing this action in the District Court."

Judge Martin held that *Barton* "has no application when jurisdiction over a matter no longer exists in the bankruptcy court. Our holding flows from *Barton* itself: when the bankruptcy court lacks jurisdiction, there are no 'powers and duties which belong[]' to that court to be usurped by the district court 'entertain[ing] jurisdiction of th[e] suit.'" *Id.* at 136.

Judge Martin said she was laying down "no categorical rule that the *Barton* doctrine can never apply once a bankruptcy case ends."

Judge Martin said she was addressing "this case only" and recognized that other circuits had applied *Barton* after the bankruptcy case had been closed. She recognized them as being "meritorious" because they identified "important policy reasons for applying the *Barton* doctrine in that context."

Having found subject matter jurisdiction, Judge Martin went on to rule that the debtor's counsel was subject to personal jurisdiction under Florida's long-arm statute. She therefore reversed the district court in part and reinstated the suit.

Observations

Finding subject matter jurisdiction isn't a matter of discretion. Traditionally speaking, it exists or it doesn't.

The result may have been based on the parties' concession that there could be no effect on the estate. Respectfully, that's wrong.

Had the bankruptcy court been told that debtor's counsel had made misrepresentations for years, it might have required the attorneys to disgorge fees, thus augmenting the estate. Furthermore, creditors might have had a thing or two to say about counsel's conduct.

If there was misconduct in bankruptcy court and misrepresentations to the bankruptcy judge, shouldn't the bankruptcy court assume the role of deciding the consequences?

On balance, this writer believes the Eleventh Circuit is saying that the court has discretion to apply *Barton* or not. A concession about the facts contrary to reality cannot confer subject matter jurisdiction. Without saying so directly, Judge Martin may have been hinting that *Barton* is not a rule of subject matter jurisdiction.

The opinion is *Tufts v. Hay*, 19-11496, 2020 BL 404293 (11th Cir. Oct. 20, 2020).

Fee allowances aren't made with the benefit of hindsight, the Fifth Circuit says.

Trustees Don't Need a Pecuniary Interest to Have Standing to Appeal, Fifth Circuit Says

A trustee has standing to appeal even without a financial interest in the outcome, according to the Fifth Circuit. In ruling on an application for compensation, hindsight is "irrelevant," Circuit Judge Jennifer Walker Elrod said in her March 5 opinion.

Two law firms were retained to represent a chapter 11 debtor. The lawyers filed and began prosecuting lawsuits against the two primary creditors challenging the priority of their claims.

The lawyers reported to the court that the debtor's chief executive had fled to Panama, allegedly taking $9 million of estate cash with him to set up the debtor's business abroad. Naturally, the bankruptcy court appointed a chapter 11 trustee.

Having been superseded by the trustee, the law firms filed final applications for reimbursement of fees they incurred in connection with the adversary proceedings prior to the appointment of the trustee.

The bankruptcy court granted the fee applications, but the district court remanded with instructions for the bankruptcy court to make findings about the commencement and litigation of the adversary proceedings.

After remand, Bankruptcy Judge Neil P. Olack of Jackson, Miss., again awarded compensation for work in the adversary proceedings because the services were reasonably likely to benefit the estate. On the second appeal, the district court reversed and vacated the fee award, saying that the adversary proceedings were "not a good gamble."

The chapter 11 trustee and the two firms appealed to the circuit. While the appeal was pending in the circuit, the two firms settled with the creditors. The Fifth Circuit granted a motion to dismiss the two firms from the appeal.

Neither the bankruptcy court, district court nor the circuit court approved the settlement. The terms of the settlement are not disclosed on the docket of any court.

With the two law firms no longer in the appeal, the creditors urged the Fifth Circuit to dismiss the appeal as moot.

Judge Elrod first addressed mootness. She said that the creditors had conflated mootness with the trustee's standing. In other words, the question was more about the trustee's standing, not mootness.

The creditors argued that the trustee lacked standing because the trustee had no pecuniary interest in the outcome following the settlement. Be that as it may, Judge Elrod said that the trustee "is distinct from all other bankruptcy parties because the trustee is responsible for the administration of the bankruptcy estate."

Judge Elrod cited the First, Sixth and Ninth Circuits for recognizing "the inadequacy of a pecuniary-interest test for trustee standing." She cited the Fourth Circuit for saying that a trustee never has a pecuniary interest.

Judge Elrod said that the Fifth Circuit had "implicitly recognized" the same principle. She observed that a "trustee's standing comes from the trustee's duties to administer the bankruptcy estate, not from any pecuniary interest in the bankruptcy."

Judge Elrod held that the appeal was not moot and the trustee had standing because "the payment of fees to [the two firms] directly affects the administration of the bankruptcy estate" and the trustee's responsibility for "ensuring that only proper payments are made from the bankruptcy estate."

Having decided the appeal was alive after settlement, Judge Elrod turned to the merits.

In the Fifth Circuit, the touchtone for an allowance is the reasonably likely benefit to the estate at the time the services were rendered. *Barron & Newburger, P.C. v. Texas Skyline, Ltd. (In re Woerner)*, 783 F.3d 266, 276 (5th Cir. 2015).

In ruling on a fee allowance, Judge Elrod said that "hindsight is irrelevant; retrospect is irrelevant; 'material benefit to the bankruptcy estate' is irrelevant. *Id.* at 273–74. 'What matters is that, prospectively, the choice to pursue a course of action was reasonable.' *Id.* at 274."

Fifth Circuit law is "clear," Judge Elrod said, that "the services must be reasonable at the time they were rendered."

Judge Elrod held that the district court was wrong in vacating "the bankruptcy court award based on its own retrospective assessment of the propriety of the adversary proceedings without giving . . . 'the deference that is the hallmark of abuse-of-discretion review.'" In other words, the "district court should have looked at the reasonableness of pursuing the adversary proceedings from the time [the two firms] provided their services."

Judge Elrod reversed and remanded for "the district court to reinstate the bankruptcy court's fee award."

Observations

But what about the settlement? How can the bankruptcy court grant fee allowances in full and fulfill the mandate of the Fifth Circuit if the two law firms settled with the creditors? If the trustee pays the firms in full, will the firms effectuate the settlement and pay back some part, and if so, to whom?

Here's the answer. The settlement may be a nullity, and the mandate must be followed.

As we said, the settlement was not approved in any court, nor were the terms of settlement disclosed. The trustee was not a party to the settlement.

The settlement entailed the very issue on appeal, namely, the amount of compensation to be paid to the two firms.

Properly speaking, the parties to the settlement should have gone to the bankruptcy court for approval of the settlement. When presented with the settlement, the bankruptcy judge would have said, "But wait, this very issue is on appeal. The appeal divests me of jurisdiction to change the fee allowance. You must ask the circuit court to remand the matter to me to pass on the settlement."

Because the bankruptcy court would not have had jurisdiction to approve the settlement, the parties did not have power to effect a valid and enforceable settlement. Therefore, the settlement might be invalid and binding on no one.

And there is another problem. Presumably, the settlement called for the two firms to give back some of the compensation that had been allowed. Who would receive the refund? Would it go to the estate or to the creditors who took the appeal?

Because the settlement was neither approved by nor disclosed to the bankruptcy court, the settlement might be seen as unauthorized and undisclosed fee-sharing.

The Fifth Circuit obviated the problems described above by having remanded with instructions to reinstate the awards by Bankruptcy Judge Olack.

The opinion is *Edwards Family Partnership LP v. Johnson (In re Community Home Financial Services Inc.)*, 20-60718, 2021 BL 80982, 2021 Us App Lexis 6661 (5th Cir. March 5, 2021).

Impliedly overruling the law in five circuits, the Supreme Court changed the rules for deciding when a deadline is jurisdictional, the Sixth Circuit says.

Sixth Circuit Creates a Split: The 14-Day Deadline for an Appeal Is Not Jurisdictional

Creating a split of circuits, the Sixth Circuit held that the 14-day deadline for filing an appeal from a bankruptcy court's order is *not* jurisdictional.

Bankruptcy Rule 8002(a)(1) is nonetheless "mandatory," the circuit court held. The appeals court therefore dismissed the appeal as "dilatory," not for lack of jurisdiction.

The facts were routine.

The bankruptcy court entered a lift-stay order on September 12, giving the debtor 14 days to appeal. The deadline was September 26, but the *pro se* debtor did not file her appeal until October 9. The district court dismissed the appeal for lack of jurisdiction, leading the debtor to appeal a second time.

Writing for the appeals court, Circuit Judge Jeffrey S. Sutton admitted that the Sixth Circuit had held in 1999 and again in 2017 that the deadline for an appeal in Bankruptcy Rule 8002(a)(1) is jurisdictional. He also cited the Third, Fifth, Seventh and Tenth Circuits for likewise holding that the deadline is jurisdictional.

In his eight-page opinion on October 28, Judge Sutton reexamined circuit court authority in light of the Supreme Court's rulings in *Arbaugh* and its progeny. *Arbaugh v. Y&H Corp.*, 546 U.S. 500 (2006).

For the unanimous Court in *Arbaugh*, the late Justice Ruth Bader Ginsburg said that Congress must "clearly state" that a requirement is jurisdictional before courts will treat the deadline as a non-waivable and non-forfeitable jurisdictional imperative. According to Judge Sutton, Justice Ginsburg was bent on limiting the "profligate" and imprecise use of "jurisdiction." *Id*. at 510.

Following *Arbaugh*, Judge Sutton said that the Supreme Court "has treated most of the procedural requirements that have come before it since then as *not* being jurisdictional in the constitutional sense of the term." [Emphasis in original.]

Judge Sutton said it was "not . . . a hard principle to apply here." Deadlines in the Bankruptcy Rules are jurisdictional, he said, "when they implement an appeal deadline created by Congress. Otherwise, they are not. Thus: A bankruptcy appellate deadline is not jurisdictional when Congress did not create it."

"Under this straightforward principle, Bankruptcy Rule 8002(a)(1)'s appeal deadline falls on the nonjurisdictional side of the line," Judge Sutton said.

The language of the statute and the rule were crucial in Judge Sutton's conclusion. 28 U.S.C. § 158(c)(2) provides that bankruptcy appeals "shall be taken in the same manner as appeals in civil proceedings generally are taken to the courts of appeals from the district courts and in the time provided by Rule 8002 of the Bankruptcy Rules."

Implementing Section 158(c)(2), Bankruptcy Rule 8002(a)(1) requires that "a notice of appeal must be filed with the bankruptcy clerk within 14 days after entry of the judgment, order, or decree being appealed."

By merely invoking the Bankruptcy Rules, Judge Sutton said that Section 158(c)(2) did "not create a clear jurisdictional limit on federal courts." He noted that the rules committee had recently changed the deadline from 10 to 14 days.

"All in all," Judge Sutton held that "Bankruptcy Rule 8002(a)(1)'s 14-day time limit for filing a notice of appeal does not create a jurisdictional imperative."

Having jurisdiction did not necessarily mean that the debtor could appeal. The words "shall" in Section 158 and "must be" in the rule are "mandatory," Judge Sutton said. He therefore dismissed the appeal as "dilatory," not for lack of appellate jurisdiction.

Observations

The opinion by Judge Sutton supports our interpretation of a decision the week before by the Eleventh Circuit in *Tufts v. Hay*, 19-11496 (11th Cir. Oct. 20, 2020).

We inferred from *Tufts* that the Eleventh Circuit views the *Barton* doctrine as a prudential limit, not a jurisdictional bar on a creditor's ability to sue a retained professional in a bankruptcy case without permission from the bankruptcy court. To read the ABI story, click here.

The opinion is *Tennial v. REI Nation LLC (In re Tennial)*, 20-5358, 2020 BL 417160 (6th Cir. Oct. 28, 2020).

Foreclosing on cash doesn't moot an appeal from the order modifying the automatic stay as to cash.

First Circuit Won't Allow a Lien to Be Waived by Implication

In an appeal raising different issues after the Supreme Court's *Tempnology* decision, the First Circuit made pronouncements about appellate jurisdiction and the interpretation of bids made at a bankruptcy auction. In sum, the appeals court ruled in its October 1 opinion that:

- Foreclosing on cash does not moot an appeal from the order permitting foreclosure.
- A pending appeal does not divest the bankruptcy court of jurisdiction over different issues when the outcome of the appeal would not take away the benefit from winning the appeal; and
- Courts are loath to read unwritten and unspoken terms into a bid made at auction.

Mission Product v. Tempnology and Its Progeny

Mission, the petitioner in the Supreme Court, was the appellant in the new appeal in the First Circuit. Before bankruptcy, Mission had obtained licenses from the debtor for intellectual property. Affirmed by the First Circuit but reversed in the Supreme Court, the bankruptcy court had ruled that rejection of the trademark license as an executory contract worked like rescission and barred Mission from continuing to use the mark.

Reversing the First Circuit in *Tempnology,* the Supreme Court held that rejection of a contract under Section 365 is just a breach giving rise to a prepetition claim, not rescission of the contract. *Mission Product Holdings Inc. v. Tempnology LLC,* 139 S. Ct. 1652 (May 20, 2019). To read ABI's report, click here.

During the appeals all the way to the Supreme Court, Mission argued that it would have a claim for its inability to use the mark were it to prevail, which it ultimately did. In bankruptcy court during the appeals, Mission objected to the sale and disposition of the debtor's property, claiming nothing would remain to pay its claim for deprivation of the trademarks.

Indeed, that's what happened. By the time the Supreme Court ruled in its favor, nothing was left in the debtor's estate. The procedural history was highly complex, but here is the gist.

Mission and the debtor's primary secured creditor bid for the debtor's assets at auction. The secured lender was the stalking horse. The lender had a valid lien on all of the debtor's assets and was making a credit bid.

In its first bid topping the lender's opening offer, Mission said it would leave $200,000 of cash in the debtor. Eventually, the lender won the auction, incorporating the same terms as Mission but leaving behind $800,000. As Circuit Judge William J. Kayatta, Jr. said in the new opinion for the First Circuit, neither the asset purchase agreement nor the sale-approval order said the lender was waiving or releasing its lien on the $800,000 in cash that it was not purchasing.

After sales, nothing was left in the estate aside from about $500,000 in cash. The secured lender filed a motion to modify the automatic stay, saying it had a valid $5 million lien, leaving the debtor with no equity in the $500,000 in cash remaining in the debtor's possession.

Over Mission's objection, the bankruptcy court modified the stay. The debtor turned the $500,000 over to the lender when requested after stay modification.

Mission unsuccessfully appealed the lift-stay order in district court and appealed a second time to the circuit. Mission and the lender raised several issues in the Court of Appeals.

The Stay-Relief Appeal Wasn't Moot

Because it had already taken possession of the $500,000, the lender argued in the circuit court that the appeal from the lift-stay order was moot. Judge Kayatta disagreed.

Unlike tangible property taken in foreclosure after the stay is modified, Judge Kayatta said that cash is fungible. For an appeal to be moot, there must be no means for giving meaningful appellate relief if the lower court is reversed.

Providing relief would be possible in the event of reversal, Judge Kayatta said. "In contrast to a case where we are unable to return title to the estate because it has been transferred to a good faith purchaser, we simply cannot say that ordering a party on appeal to disgorge mere cash is impracticable and does not afford meaningful appellate relief."

Judge Kayatta added that there was no "judicial sale order," nor an actual purchaser relying on a sale order. As a result, there was no risk of undermining the integrity of a judicial sale.

At least when the collateral being foreclosed is cash, Judge Kayatta held that an appeal from a lift-stay order was neither equitably moot, moot under Article III of the Constitution, nor moot under the Bankruptcy Code or Rules.

A Pending Appeal Didn't Divest Jurisdiction

Mission argued that its appeal to the Supreme Court divested the bankruptcy court of jurisdiction to lift the stay, because allowing foreclosure would take away the last estate property that could be used to satisfy its claim for deprivation of the trademarks.

Judge Kayatta wasn't buying. He had just held that the circuit court could order disgorgement if the lender was not entitled to the $500,000.

The priority of claims was also pivotal. The bankruptcy court had ruled in substance that a claim by Mission would be subordinate to the lender's secured claim. Therefore, he said, the appeal to the Supreme Court did not divest the bankruptcy court of jurisdiction because allowing foreclosure would "not take away any benefit" that might flow from an appeal to the Supreme Court.

Foreclosure Was Ok on the Merits

On the merits of modifying the stay, Mission conceded there was no equity in the $500,000 if the lien was valid and enforceable. Instead, Mission contended that the lender "implicitly surrendered its lien" by omitting the $800,000 from the assets being purchased.

Again, Judge Kayatta wasn't buying.

Judge Kayatta said that Mission was saying that "we should assume" that the lender was releasing its lien. He noted, however, that neither the purchase contract nor the sale approval order "contained any reference to such a waiver or release."

It "makes no sense," Judge Kayatta said, that "merely . . . agreeing to leave assets in the estate" results in releasing the lien. "Were that premise correct," he said, "many Section 363(f) sales would turn into lien laundries." There was, he added "no caselaw to justify such alchemy."

"It would be strange," Judge Kayatta said, if a lien were waived because an asset was not sold at auction.

Judge Kayatta upheld the order modifying the stay. Mission's argument about waiver made no sense, "for a slew of reasons," he said. "Waiver of a first secured lien on cash is no small matter — hardly something that would be offered only on an implication so tenuous as that claimed by Mission."

The opinion is *Mission Product Holdings Inc. v. Schleicher & Stebbins Hotels LLC (In re Old Cold LLC)*, 19-9004, 2020 BL 378410 (1st Cir. Oct. 1, 2020).

Third Circuit's Judge Bibas says that courts use the wrong nomenclature when they say that creditors lack standing to pursue claims belonging to the estate. It's a question of statutory authority, he said, not standing.

Creditors Have Standing but Not Authority to Pursue Estate Claims, Third Circuit Says

Third Circuit Judge Stephanos Bibas used a bankruptcy case to author a peroration on the distinction between standing and statutory authority to pursue a claim.

Surprisingly, Judge Bibas teaches in his August 4 opinion that a creditor ordinarily *will* have standing to pursue a claim belonging to a bankruptcy estate. However, the creditor may lack statutory authority to assert the claim unless the trustee has abandoned the claim or the creditor has suffered a direct, particularized injury.

Judge Bibas gave us a lesson on the proper use of language and labels based on a case where a creditor had sued two third parties before bankruptcy, alleging they helped the debtor plunder and conceal assets.

Following the advent of bankruptcy, the chapter 7 trustee pursued some of the claims originally brought by the creditor. Ultimately, the trustee obtained court orders abandoning claims that were not liquidated. Affirmed in district court, the bankruptcy judge held that the creditor did not have standing to pursue claims against the defendant because they were not abandoned.

Caplin Led the World Astray

Judge Bibas said the Supreme Court led the world astray in *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), where the Court spoke about the standing of creditors to prosecute claims belonging to the estate.

For example, the liquidation of Bernard Madoff's Ponzi scheme has made reams of law about the inability of individual creditors to sue deep pockets who were in cahoots with the fraudster. *See, e.g.*, *Marshall v. Picard (In re Bernard L. Madoff Inv. Sec. LLC)*, 740 F.3d 81 (2d Cir. 2014)). In effect, Judge Bibas tells us that the Second Circuit used the wrong word in saying that an individual creditor lacked standing to sue someone who assisted Madoff.

Judge Bibas admitted that his circuit, along with the Fourth and Fifth Circuits, had followed *Caplin* by referring to the standing of a trustee to assert claims.

Judge Easterbrook Had Set Things Right

Judge Bibas lauded Seventh Circuit Judge Frank Easterbrook for correcting the nomenclature in *Grede v. Bank of N.Y. Mellon*, 598 F.3d 899 (7th Cir. 2010). Judge Easterbrook in substance said that bankruptcy standing is more properly the trustee's "authority" to act for the estate.

The Supreme Court Corrects Its Own Mistake

The Supreme Court evidently learned a lesson from Judge Easterbrook as well. In *Lexmark Int'l Inc. v. Static Control Components, Inc.*, 572 U.S. 118 (2014), the Supreme Court proclaimed that constitutional standing is established by "only three elements: (1) 'a concrete and particularized injury in fact,' (2) that is 'fairly traceable' to the defendant's conduct, and (3) that a favorable judicial decision would likely 'redress[].'" *Id*. at 125.

"Once a plaintiff satisfies those elements," the Supreme Court said, "the action 'presents a case or controversy that is properly within federal courts' Article III jurisdiction.'" *Id.*

In light of *Lexmark*, Judge Bibas said it was incorrect for the lower courts to proclaim that the creditor lacked standing to sue third parties for denuding the estate. The creditor had sustained particularized injury traceable to the defendants' conduct that could be redressed in court. The creditor therefore possessed standing, he said.

Standing, Yes; Authority, No

Having established standing, Judge Bibas turned to the merits and analyzed whether the creditor had statutory authority to pursue the claims.

Of course, the creditor lost statutory authority to sue third parties on the advent of bankruptcy. As Judge Bibas said, "The Bankruptcy Code thus gives the statutory authority to pursue those claims to the trustee."

What the creditor lost in bankruptcy, however, the creditor regained when the trustee abandoned the claims. Quoting the *Collier* treatise, Judge Bibas said that abandoned property "can flow back 'to any party with a possessory interest in it.'" When a cause of action is abandoned, he said, it reverts to the prior holder.

In a final helping of scholarship, Judge Bibas clarified the holding in the Third Circuit's opinion in *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp.*

v. Chinery (In re Cybergenics Corp.), 226 F.3d 237 (3d Cir. 2000). The case holds, he said, that "Chapter 7 trustees can abandon asset-plundering claims back to the creditors who had them before the bankruptcy."

The lower courts erred in interpreting the bankruptcy court's abandonment order, Judge Bibas said. Taking a fresh look, he concluded that the trustee indeed had abandoned the claims, thus allowing the creditor to pursue claims against third parties.

Before his appointment to the circuit bench, Judge Bibas was a law professor at the University of Pennsylvania. He also clerked on the Fifth Circuit and for Supreme Court Justice Anthony M. Kennedy.

The opinion is *Artesanias Hacienda Real S.A. de C.V. v. North Mill Capital LLC (In re Wilton Armetale Inc.)*, 19-2907 (3d Cir. Aug. 4, 2020).

In a removed action, nationwide service under Bankruptcy Rule 7004 can give a district court personal jurisdiction, even though the state court would lack personal jurisdiction.

Circuits Split on Applying Derivative Jurisdiction to a Lack of Personal Jurisdiction

Creating a split of circuits, the Eleventh Circuit held that the doctrine of derivative jurisdiction only applies to the subject matter jurisdiction, not personal jurisdiction.

In substance overruling one of his circuit's own precedents in light of an amendment to 28 U.S.C. § 1441(f), Circuit Judge Adalberto Jordan decided that a federal court after removal can have personal jurisdiction under 28 U.S.C. § 1334, even if the state court would not have long-arm jurisdiction over the defendant.

The Removed Lawsuit

A chapter 7 bankruptcy trustee sued the owners of a corporate debtor in state court to recover a $30 million dividend paid five years before bankruptcy. The defendants removed the suit to federal court under 28 U.S.C. § 1441, the statute allowing removal to federal court based on diversity or federal question jurisdiction.

After removal, the defendants filed a motion to dismiss, claiming they were not subject to jurisdiction in state court based on the state's long-arm jurisdiction. The trustee countered by arguing that the defendants were subject to nationwide jurisdiction under Bankruptcy Rule 7004 because the federal court had "related to" bankruptcy jurisdiction under Section 1334.

Despite finding that it had bankruptcy jurisdiction under Section 1334, the district court dismissed the suit, reasoning that the doctrine of derivative jurisdiction required the federal court to dismiss because the state court lacked personal jurisdiction.

Derivative Jurisdiction Explained

Judge Jordan devoted pages to explaining the history of derivative jurisdiction. The doctrine was born in 1922 in *Lambert Run Coal Co. v. Baltimore & O.R. Co.*, 258 U.S. 377, 382 (1922), where the Supreme Court ruled that the federal court lacked subject matter jurisdiction in a removed lawsuit because the state court did not have subject matter jurisdiction.

In *dicta* in later cases, Judge Jordan said, the Supreme Court said that derivative jurisdiction applied also to instances where the state court lacked personal jurisdiction. Several circuits, including the Eleventh Circuit, held that derivative jurisdiction applies to personal jurisdiction, not only to subject matter jurisdiction.

Judge Jordan explained how Congress ostensibly overruled *Lambert* years later in what now resides in Section 1441(f). In a removed action, the section says that a federal court "is not precluded from hearing and determining any claim in such civil action because the state court from which such civil action is removed did not have jurisdiction over that claim."

The Split Regarding Personal Jurisdiction

Judge Jordan said that "a number of circuits have applied the doctrine of derivative jurisdiction to require dismissal in cases where the state court, prior to removal, lacked personal jurisdiction over the defendants (usually due to ineffective service of process)."

Even giving the Supreme Court's *dicta* "the respect and consideration it is due," Judge Jordan chose "to go in a different direction" by holding that "that the doctrine of derivative jurisdiction does not apply in cases where the state court lacks personal jurisdiction over the defendants."

Prominently, Judge Jordan declined to follow high court *dicta* given the Supreme Court's own pronouncements that federal law governs procedure once a case has been removed, citing *Granny Goose Foods Inc. v. Brotherhood of Teamsters & Auto Truck Drivers Local No. 70*, 415 U.S. 423, 438 (1974). He therefore could not understand "why a federal statute or rule governing personal jurisdiction (including one providing for nationwide service of process) would not control following the removal of a case from state court."

Having ruled that the federal court did not lack personal jurisdiction under derivative jurisdiction, Judge Jordan remanded for the district court to determine whether there was personal jurisdiction under Bankruptcy Rule 7004(d).

If personal jurisdiction in the state would be "unconstitutionally burdensome," Judge Jordan said that the district court could transfer venue under 28 U.S.C. § 1406 to a district where the defendants are located.

The opinion is *Reynolds v. Behrman Capital IV PL*, 19-13537, 2021 BL 62158 (11th Cir. Feb. 23, 2021).

Section 106 wasn't sufficiently explicit to waive sovereign immunity for Indian tribes, Judge Frank Bailey said in siding with the Sixth Circuit and differing with the Ninth Circuit.

On a Circuit Split, Sovereign Immunity Wasn't Waived for Indian Tribes, Judge Says

Taking sides on a circuit split, Bankruptcy Judge Frank J. Bailey of Boston held that the Bankruptcy Code does not waive sovereign immunity with respect to Indian tribes, even though Sections 106 and 101(27) effect a broad waiver for other governmental units.

The chapter 13 debtor alleged that the defendants violated the automatic stay after he filed a chapter 13 petition by making phone calls and sending emails to collect a $1,600 payday loan. The defendants were a federally recognized Indian tribe and three entities that were "arms" of the tribe.

The defendants filed a motion to dismiss, contending that a claim for violation of the automatic stay is barred by tribal sovereign immunity.

Citing the Supreme Court in his October 19 opinion, Judge Bailey said that tribes have a direct relationship with the federal government, thus conferring sovereign immunity on the tribe and its arms.

However, Section 106(a) abrogates sovereign immunity "as to a governmental unit" with respect to enumerated sections of the Bankruptcy Code, including Section 362, under which the debtor was suing the tribe.

In turn, Section 101(27) defines "government unit" to "mean" (not "include"), among other things, the U.S., states, municipalities, foreign states or "other foreign or domestic government."

Judge Bailey noted that Section 101(27) does not specifically include tribes as governmental units. Thus, he was tasked with deciding whether Section 106(a) abrogates sovereign immunity for tribes.

The debtor urged Judge Bailey to follow the Ninth Circuit by holding that Congress did express an unequivocal intent to waive immunity for tribes. *See Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055 (9th Cir. 2004). The tribe urged the judge to adopt the Sixth Circuit's holding in *Buchwald Capital Advisors LLC v. Sault Ste. Marie Tribe of Chippewa Indians (In re Greektown Holdings LLC*), 917 F.3d 451 (6th Cir. Feb. 26, 2019).

In a 2/1 decision, the Sixth Circuit in *Buchwald* said that the "real question" is "whether Congress . . . unequivocally expressed an intent to abrogate tribal sovereign immunity." *Id*. at 459. The majority held that Sections 106 and 101(27) "lack the requisite clarity of intent to abrogate tribal sovereign immunity." *Id*. at 461. To read ABI's report on *Buchwald*, click here.

Judge Bailey said that *Krystal* had been rejected in two other circuits, in addition to the Sixth.

Based on sovereign immunity, Judge Bailey sided with *Buchwald* and dismissed the suit for lack of subject matter jurisdiction. He said that the debtor "ignores the special place that Indian tribes occupy in our jurisprudence."

Stay tuned for an appeal to see how the split develops. The question will end up in the Supreme Court someday.

The opinion is *In re Coughlin*, 19-14142, 2020 BL 404982, 2020 Bankr Lexis 2946 (Bankr. D. Mass. Oct. 19, 2020).

Congress may have made a mistake in drafting, but the plain language of 28 U.S.C. § 1409(b) must control, Judge Grossman says.

'Plain Language' Puts Small-Dollar Avoidance Suits in the Debtor's Home Court

On a question where courts are divided, Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., came down emphatically on the side of plain language by holding that a trustee may bring a small-dollar preference suit in the debtor's home court, even if Congress may have made a mistake in drafting 28 U.S.C. § 1409(b).

The debtor paid $11,400 to a supplier within 90 days of bankruptcy. The trustee sued for recovery of a preference under Sections 547 and 550.

The creditor was a Delaware corporation with a principal place of business in California. It had no connections with New York other than having sold goods to the debtor in New York. The creditor had filed a claim for more than $190,000.

The creditor filed a motion to dismiss based on improper venue. The creditor contended that the preference suit arose in the bankruptcy case, making venue improper under 28 U.S.C. § 1409(b).

The outcome turned on Section 1409. With exceptions provided in subsections (b) and (d), subsection (a) allows for venue of "a proceeding arising under title 11 or arising in or related to a case under title 11" in the district where the bankruptcy case is pending.

For a proceeding to recover a non-consumer debt of less than $25,000 owing by a noninsider, subsection (b) places venue in "the district in which the defendant resides" for "a proceeding arising in or related to" a bankruptcy case.

Notably, the language of subsection (b) does not place venue in the creditor's district for small-dollar suits "arising under" title 11.

Did the preference action "arise in" the chapter 7 case, thus compelling suit in the creditor's district, not in the debtor's home court? Linguistically speaking, "arising in" and "arising under" might seem overlapping, synonymous or interchangeable.

Judge Grossman disagreed in his January 26 opinion. "The terms 'arising under' and 'arising in' are not interchangeable," he said. On that score, he took issue with the Ninth Circuit Bankruptcy Appellate Panel. *See Muskin, Inc. v. Strippit Inc.* (*In re Little Lake Indus.)*, 158 B.R. 478 (B.A.P. 9th Cir. 1993).

Judge Grossman paraphrased the B.A.P. and some other courts as believing "that Congress did not intend to exclude cases arising under title 11 from the restrictions in subsection (b)." He noted, however, that Congress left "arising under" out of subsection (b).

"It is beyond question," Judge Grossman said, "that a preference action 'arises under' title 11. Thus, a plain reading of § 1409(a) and (b) compels the Court to conclude that venue of this proceeding is proper in the [the debtor's home court]."

Judge Grossman said he appreciated "the thoughtfulness of courts who perceive an error that must be corrected." Still, he said, "the language of § 1409 is unambiguous. It is apparent that the 'arising under' language is included in subsection (a) and omitted from subsection (b). *See* § 1409. Therefore, based on the lack of ambiguity, this Court will defer to the plain language of the statute as written by Congress."

As support for his conclusion, Judge Grossman cited a June 2020 decision by District Judge Joanna Seybert of Central Islip, N.Y. *Novak v. Parts Authority LLC*, 20-2948 (E.D.N.Y. June 16, 2020). According to Judge Grossman, she "held that preference actions 'arise under' title 11 and therefore do not fall within the ambit of § 1409(b)." To read ABI's report on *Novak*, click here.

The opinion is *Mendelsohn v. Central Garden & Pet Co. (In re Petland Discounts Inc.)*, 20-08088, 2021 BL 30084 (Bankr. E.D.N.Y.).

Plans & Confirmation

Pragmatic opinion by Circuit Judge Ambro allows cramdown to achieve 'rough justice.'

Cramdown Doesn't Require Strict Enforcement of Subordination, Third Circuit Says

The Third Circuit ruled "that subordination agreements need not be strictly enforced for a court to confirm a cramdown plan."

The Third Circuit upheld rulings by the bankruptcy court and the district court in the mammoth reorganization of publisher Tribune Co. Senior noteholders, whose class voted against the chapter 11 plan, wanted the Third Circuit to enforce their contractual subordination rights to the letter.

The appeals court declined the invitation. In his August 27 opinion, Circuit Judge Thomas L. Ambro said that the "unfair discrimination" provision in Section 1129(b)(1) is "rough justice." It replaces "stringent requirements with more flexible tests that increase the likelihood that a plan can be negotiated and confirmed."

Judge Ambro wrote a "masterful opinion," according to Bruce A. Markell, Professor of Bankruptcy Law and Practice at the Northwestern Univ. Pritzker School of Law. Judge Ambro is someone "with lots of bankruptcy experience and good horse sense," Prof. Markell told ABI.

Prior Appeals and Procedural History

Bankruptcy Judge Kevin J. Carey confirmed the Tribune plan in July 2012. Two groups of bondholders appealed. In August 2015, the Third Circuit upheld dismissal of the appeal by one group of bondholders, ruling that the appeal was equitably moot.

However, the Third Circuit reversed the district court by holding that a separate appeal by senior noteholders was not equitably moot because it would not be unfair if the class that received an extra $30 million were forced to pay it back. In *In re Tribune Media Co.*, 799 F.3d 272 (3d Cir. 2015).

On remand, the senior noteholders argued that the plan discriminated unfairly against them and thus violated Section 1129(b)(1), because some of the recovery they would have received from subordinated debt holders was directed to other creditors.

Confirmation Upheld on Remand

As the plan was written and confirmed, the district court determined on remand that the dissenting bondholders would receive a recovery of 33.6%. If subordination were strictly enforced, the bondholders' recovery would have risen to 35.9%, a difference of 2.3 percentage points. In other words, the recovery would have been about 7% larger if subordination had been fully enforced.

Analyzing Sections 510(a) and 1129(b)(1) on remand, the district court rejected the bondholders' contention that the plan discriminated unfairly because the plan did not strictly enforce the subordination agreement.

The district court held that "[m]inor or immaterial differences . . . do not rise to the level of unfair discrimination." The plan did not unfairly discriminate, the court said, because the dissenting class would receive "a percentage recovery that was, at most, 2.3 percentage points lower than the recovery to which they claim they were entitled."

"While the actual amount of money at issue is large," the district court said that "the percentage difference is not significant or material," meaning there was no presumption of unfair discrimination.

The district court upheld confirmation and ruled against the senior noteholders. *In re Tribune Media Co.*, 587 B.R. 606 (D. Del. 2018). To read ABI's report about the decision on remand, click here.

The senior bondholders appealed but lost in the opinion by Judge Ambro that tracks and amplifies the decision by the bankruptcy and district courts.

'Notwithstanding' Nixes Section 510(a)

The appeal turned on Sections 510(a) and 1129(b)(1). Section 510(a) says that a "subordination agreement is enforceable [in bankruptcy] to the same extent that such agreement is enforceable under applicable nonbankruptcy law."

Section 1129(b)(1) is one of the so-called cramdown provisions that permits confirmation of a chapter 11 plan over a dissenting class. "Notwithstanding section 510(a)," it provides that the court "shall confirm the plan" despite rejection by the dissenting class "if the plan does not discriminate unfairly, and is fair and equitable. . . ."

The Third Circuit, Judge Ambro said, has written often about the "fair and equitable" requirement, also known as the absolute priority rule. On the other hand, "the unfair-discrimination standard has received little analysis."

Judge Ambro quickly concluded that "§ 1129(b)(1) overrides § 510(a) because that is the plain meaning of '[n]otwithstanding.'" The purpose of the section, he said, is to provide "flexibility to negotiate a confirmable plan even when decades of accumulated debt and private ordering of payment priority have led to a complex web of intercreditor rights." It ensures that plans will "not have *carte blanche* to disregard pre-bankruptcy contractual arrangements, while leaving play in the joints."

Judge Ambro therefore held "that subordination agreement need not be strictly enforced for a court to confirm a cramdown plan."

How Much Is Too Much?

Next, Judge Ambro was tasked with deciding whether the deprivation of $30 million represented "unfair discrimination." He began by noting how the plan gave the dissenting class a recovery of 33.6%. Were the subordination agreement enforced, the dissenting bondholders would have recovered 34.5%. To the bankruptcy court, the difference of 0.9% was not material and therefore did not amount to unfair discrimination.

Courts have come up with four tests to determine when discrimination is too much. The parties agreed that Prof. Markell wrote the test in *A New Perspective on Unfair Discrimination in Chapter 11*, 72 Am. Bankr. L.J. 227, 227–28 (1998). Given the parties agreement, Judge Ambro applied the Markell test but did not say that it is the proper test.

The Markell test establishes a rebuttable presumption of unfair discrimination. Applicable to the case on appeal, the presumption arises if the failure to enforce subordination results in "a materially lower percentage recovery." The presumption can be overcome, Judge Markell said, if the "lower recovery for the dissenting class is consistent with the results that would obtain outside of bankruptcy, or that a greater recovery for the other class is offset by contributions from that class to the reorganization."

Applying the test, Judge Ambro said that there must be a "materially lower percentage recovery" for the presumption to arise. By approving a plan where the recovery was 0.9% lower, he said that the bankruptcy court "did not necessarily err." He went on hold that the difference was "not material."

Judge Ambro said that a "typical" reorganization has "a need for flexibility over precision." Although the Tribune plan did discriminate, he said it was not "presumptively unfair" because "a cramdown plan may reallocate some of the subordinated sums."

Judge Ambro did not lay down a rule saying how much discrimination is too much. He did say that 0.9% "is, without a doubt, not material." He therefore upheld the "pragmatic approach" taken by the bankruptcy and district courts.

The opinion is *In re Tribune Co.*, 18-2920, 2020 BL 324360 (3d Cir. Aug. 26, 2020).

New York district judge differs with the Third Circuit on a bankruptcy court's constitutional power to issue nondebtor, third-party releases.

No 'Core' Jurisdiction to Protect Nondebtors with Injunctions, N.Y. District Judge Says

It was not surprising when Chief District Judge Colleen McMahon of New York City upheld the bankruptcy court's preliminary injunction barring private litigants and government officials from suing nondebtor officers of opioid manufacturer Purdue Pharmaceuticals LP.

However, it may come as a surprise to learn that Judge McMahon ruled that the bankruptcy court did not have "arising in" jurisdiction to form the basis for the preliminary injunction. Instead, she held that the bankruptcy court had only non-core, "related to" jurisdiction to underpin the injunction.

The August 11 opinion seems to say that the bankruptcy court may only issue a report and recommendation if the debtor's chapter 11 plan includes a permanent injunction protecting nondebtors. In other words, a non-consensual third-party release in a plan may be subject to *de novo* review in district court. Consequently, the debtor might be unable to consummate a confirmed plan, even in the absence of an appeal, until the district court has reviewed aspects of the plan where jurisdiction was only "related to."

By finding that the bankruptcy court lacked core jurisdiction, Judge McMahon's decision seems to part company with a recent decision by the Third Circuit in *Opt-Out Lenders v. Millennium Lab Holdings II LLC (In re Millennium Lab Holdings II LLC)*, 945 F.3d 126 (3d Cir. Dec. 19, 2019). In *Millennium*, the Third Circuit found constitutional authority in the bankruptcy court to grant nondebtor, third-party releases.

Curiously, Judge McMahon's decision is arguably at odds with the broader language in her own opinion from October 2018 in *Lynch v. Lapidem Ltd. (In re Kirwan Offices SARL)*, 592 B.R. 489 (S.D.N.Y. Oct. 10, 2018), *aff'd sub nom. Lynch v. Mascini Holdings Ltd. (In re Kirwan Offices SARL)*, 792 F. App'x 99 (2d Cir. 2019). To read ABI's report, click here.

The District Attorneys' Civil Suits

Six months before Purdue's bankruptcy, five district attorneys in Tennessee mounted a lawsuit under state law against the opioid maker and its former president and co-chairman. The statute

gave the plaintiffs a right of action for damages against those who participated in an illegal drug market in the state.

One month before Purdue's chapter 11 filing, the district attorneys moved for summary judgment against the co-chairman as to liability. Immediately after bankruptcy, the debtor filed a motion for preliminary injunction to halt 2,600 governmental enforcement and private lawsuits in state and federal courts against the company's nondebtor owners, officers and directors, including the co-chairman.

The bankruptcy court granted a five-month preliminary injunction followed by a six-month extension. The Tennessee district attorneys appealed both injunctions. Judge McMahon upheld the preliminary injunction, but with significant caveats regarding jurisdiction.

Court Finds "Related To" Jurisdiction

The district attorneys argued that the bankruptcy court lacked jurisdiction to support the injunctions.

Judge McMahon found "related to" jurisdiction, because the suit in state court against the co-chairman might have a "conceivable effect" on the corporate bankruptcy.

From Second Circuit authority stemming from Bernard Madoff's Ponzi scheme, Judge McMahon said "that when one tortfeasor files for bankruptcy, any action against their co-tortfeasors for the same conduct falls within the bankruptcy court's 'related to' jurisdiction, since a finding of joint and several liability against the whole group could impact the *res* of the insolvent party's estate." *See SPV Osus Ltd. v. UBS AG*, 882 F.3d 333, 342 (2d Cir. 2018). In other words, she said, there was a conceivable effect because "the individual case is likely to raise the issue of the corporate entity's liability, even if only indirectly."

There was also a conceivable effect, Judge McMahon said, because the co-chairman may have rights of indemnity and contribution from the debtor. Unlike the Third Circuit, she said that the Second Circuit does not require "the intervention of another lawsuit" before there is "related to" jurisdiction in those circumstances. *Cf. In re Combustion Engineering Inc.*, 391 F.3d 190, 227 (3d Cir. 2004).

Therefore, the bankruptcy court had "related to" jurisdiction to underpin the injunction. As a preliminary injunction lacking finality, there was no question about the effectiveness of the bankruptcy court's order without district court review.

But There Was No "Arising In" Jurisdiction

The bankruptcy court had also found "arising in" jurisdiction to support the injunction. The bankruptcy court reasoned that the injunction arose in bankruptcy to enable sufficient time to foster negotiation of a settlement and plan. Judge McMahon disagreed.

Judge McMahon said that the state law claims against the co-chairman were "entirely independent of the bankruptcy proceeding; they arise under a state statute and they were filed months before there was any bankruptcy. Neither the [state statute] nor the lawsuit references or depends on any order of the Bankruptcy Court for their existence."

Because "arising in" proceedings are "core," but because the claims against the co-chairman did not "arise in" the bankruptcy case, Judge McMahon said that the bankruptcy court did not have authority to characterize the injunction against the co-chairman under Section 105(a) as a "core" proceeding.

Judge McMahon was not finished. She made several assumptions affecting the bankruptcy court's final adjudicatory authority as the chapter 11 case unfolds.

If there were a final, enforceable settlement agreement, if it were incorporated into a confirmable chapter 11 plan, and if an "arising in" jurisdictional argument were to arise "in the context of a confirmation fight," Judge McMahon said that "the Bankruptcy Court would still not be exercising core jurisdiction over the [state law] claims by confirming the plan."

There was more. Judge McMahon said that the "Bankruptcy Court cannot now, nor will it ever be able to, adjudicate the [state law] claims against [the co-chairman] without first being permitted to do so by this court, reviewing an order of the Bankruptcy Judge *de novo*."

Although there was no "arising in" jurisdiction, Judge McMahon upheld issuance of the preliminary injunction given "related to" jurisdiction. She found no abuse of discretion under the traditional standards for a preliminary injunction.

However, Judge McMahon vacated portions of the preliminary injunction that referred to the suits as "core" proceedings. She remanded "for further proceedings with respect to the other [lawsuits against officers, directors and owners] that are not the subject of this appeal."

Observations

Finding no core jurisdiction for injunctions protecting nondebtors, Judge McMahon's opinion seems at odds with the Third Circuit's recent decision in *Millennium*. To read ABI's report, click here.

In *Millennium*, the Third Circuit found constitutional power for the bankruptcy court to enter a final order granting releases to company insiders who posted $325 million to fund a

reorganization plan. The appeals court said the releases were constitutionally appropriate because there would have been no reorganization and no plan confirmation absent the $325 million contributed by the shareholders in return for releases.

In Purdue's reorganization, insiders might end up posting several billion dollars to fund a chapter 11 plan, in return for which they would be granted releases and injunctions barring creditors from suing them. Contrary to Judge McMahon's holding, it seems as though the Purdue bankruptcy judge would have final adjudicatory power to grant releases were the case in the Third Circuit.

In *Kirwan* in 2018, Judge McMahon appeared to hold that bankruptcy courts possess core jurisdiction and constitutional power to enter chapter 11 confirmation orders, including so-called nondebtor, third-party releases of non-bankruptcy claims. It is possible that Judge McMahon would find core jurisdiction for third-party releases as part of confirmation, but not at the stage of a preliminary injunction.

In her *Perdue* opinion, Judge McMahon said the bankruptcy court would not have core jurisdiction to "*adjudicate* the [state law] claims against [the co-chairman]." [Emphasis added.] However, the bankruptcy court at confirmation would not be adjudicating the state law claims. It would be entering an injunction in aid of confirmation.

The Second and Third Circuits have generally been on the same page when it comes to authorizing third-party, nondebtor injunctions in chapter 11 plans. However, the Second Circuit has not pinned down the bankruptcy court's constitutional power as succinctly as the Third Circuit.

The opinion is *Dunaway v. Purdue Pharmaceuticals LP (In re Purdue Pharmaceuticals LP)*, 19-10941 (S.D.N.Y. Aug. 11, 2020).

Dissenter would have upheld horizontal gifting on the merits.

Third Circuit Upholds Equitable Mootness over a Dissent

Over dissent, the Third Circuit held that an appeal from confirmation of a chapter 11 plan is equitably moot even if the appellant is only asking the appellate court to pay one relatively small claim and no others.

The case involved horizontal gifting. In a nonprecedential opinion on January 6, Circuit Judge Kent A. Jordan dismissed the appeal as equitably moot and did not reach the question of gifting. Concurring in the result but dissenting on equitable mootness, Circuit Judge Cheryl Ann Krause did not believe the appeal was moot but said she would have affirmed on the merits.

One Creditor Appeals Confirmation

The debtor had $500 million in secured debt and a business worth about $300 million. The prepackaged chapter 11 plan called for converting secured debt to equity, amounting to a recovery of perhaps 55% on the secured claims.

The secured creditors made what is known as a gift to unsecured creditors in the form of cash and stock to holders of unsecured notes whose recovery amounted to no more than 6% of the claims in the class. Trade and some other unsecured creditors were to be paid in full.

The noteholder class voted against the plan, but Bankruptcy Judge Kevin J. Carey of Delaware employed cramdown to confirm the plan. A holder of about $500,000 in unsecured notes appealed from the confirmation order and unsuccessfully sought a stay pending appeal.

On appeal in district court, the noteholder argued that the appeal was not equitably moot because the appellate court could order payment of its $500,000 claim in full without upsetting the plan as a whole and without paying the entire class and its $40.5 million in claims.

In August 2018, District Judge Richard G. Andrews upheld confirmation. He reached the merits of gifting after ruling that the appeal from confirmation was equitably moot because the plan had been substantially consummated. *Hargreaves v. Nuverra Environmental Solutions Inc. (In re Nuverra Environmental Solutions Inc.)*, 590 B.R. 75 (D. Del. Aug. 21, 2018). To read ABI's report, click here.

Judge Andrews rejected the idea of paying one creditor, saying there was no method under the Bankruptcy Code to permit paying the appellant in full without paying all other noteholders in full. Paying one creditor in the noteholder class, he said, would offend Section 1123(a)(4) and its requirement of making identical payments to all creditors in a class.

Despite ruling that the appeal was moot, Judge Andrews analyzed the merits and upheld confirmation. The noteholder appealed.

Majority Finds the Appeal to Be Equitably Moot

The noteholder argued in the circuit court that the appeal was not moot because the appeals court could order payment of his $500,000 claim without upsetting the debtor's finances or upsetting the plan.

Judge Jordan rejected the argument. Paying only one claim in the class, he said, "would violate the Code's restriction [in Section 1123(a)(4)] on preferring certain individuals over others in the same class." He went on to say that ordering payment of one claim would also "contravene the . . . unfair discrimination provision" in Section 1129(b)(1).

In other words, "an individual payout to one member of a class is not permitted by the Code," Judge Jordan said. To the contrary, "the sole relief an objecting party can pursue when alleging unfair discrimination is relief for the class of creditors unfairly discriminated against, consistent with 11 U.S.C. § 1123(a)(4)."

Judge Jordan dismissed the appeal as equitably moot.

Concurrence Rails Against Equitable Mootness

Quoting one of her prior concurring opinions, Judge Krause said that "our equitable mootness doctrine is 'legally ungrounded and practically unadministrable,' and I have urged my colleagues to 'reconsider whether it should exist at all.'"

The case on appeal, Judge Krause said, exemplified "the consequences of our ill-advised expansion of the doctrine."

In her view, Judge Krause said that the appeal would neither harm the interests of third parties nor "endanger the reorganized debtors' solvency or unwind other aspects of the Plan." Those considerations alone, she said, "should end our equitable mootness inquiry and require us, in the normal course, to analyze the merits of [the noteholder's] claims."

Judge Krause listed several issues that the circuit court should examine. For instance, she said that the appellant had a "colorable claim" that the remaining members of the class waived the

unfair discrimination claim. She wanted to know whether *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017), foreclosed the notion of horizontal gifting. She also asked, "what are the limits on a plan's ability to divide creditors into classes?"

Without addressing the merits, she said, in substance, that the doctrine of equitable mootness will preclude the Third Circuit from ever ruling on the propriety of gifting.

Judge Krause dissented on equitable mootness but concurred in affirming the district court. On the merits regarding unfair discrimination, she limited her comment to saying that she would "ultimately resolve this appeal in favor of the reorganized debtors."

The opinion is *Hargreaves v. Nuverra Environmental Solutions Inc. (In re Nuverra Environmental Solutions Inc.)*, 17-1024 (3d Cir. Jan. 6, 20921).

Confirmation appeals in two big cases are dismissed on the same day for equitable mootness.

Tempnology Didn't Undercut the Validity of Equitable Mootness, First Circuit Says

The Supreme Court's *Tempnology* decision did not undercut the validity of the doctrine of equitable mootness used to dismiss appeals from chapter 11 confirmation orders, according to the First Circuit. *See Mission Product Holdings Inc. v. Tempnology LLC*, 139 S. Ct. 1652 (2019). The Boston-based appeals court did say that equitable mootness is more accurately characterized as equitable laches.

The First Circuit's February 8 opinion also held that equitable mootness applies in arrangement proceedings to restructure the debt of Puerto Rico and its instrumentalities under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*).

On the same day, a district court in Oakland, Calif., invoked equitable mootness to dismiss an appeal from the order confirming the chapter 11 plan for giant electric utility PG&E Corp.

The Cofina Plan

In his opinion for the Boston-based appeals court, Circuit Judge William J. Kayatta, Jr. explained how Puerto Rico created an entity known as Cofina to issue bonds to cover budget shortfalls. The 2006 law granted a statutory lien carving out a portion of sales tax revenue exclusively for Cofino bondholders.

With Puerto Rico, Cofina and the island commonwealth's instrumentalities in PROMESA proceedings, a dispute broke out between the Cofina bondholders and the holders of general obligation bonds. A settlement evolved in mediation that was incorporated into Cofina's plan. The settlement and the plan gave about 54% of sales tax revenue to Cofina bondholders.

Several junior Cofina bondholders objected to the plan and appealed when the plan was confirmed over their objections. The appealing bondholders did not seek a stay, and the plan was consummated. As a result of consummation, Judge Kayatta said that Cofina distributed $322 million to creditors plus $1 billion in sales tax revenues to the commonwealth and Cofina. Newly issued Cofina bonds traded tens of thousands of times, and lawsuits were dismissed with prejudice.

Puerto Rico's Financial Oversight Management Board and others filed a motion to dismiss the appeal as equitably moot.

Equitable Mootness Defined

Like all other circuits, the First Circuit adopted a form of equitable mootness.

The appealing bondholders argued that *Tempnology* made the doctrine invalid, because the Supreme Court decided that the appeal was not moot even though the debtor had distributed all its cash. To read ABI's report on *Tempnology*, click here.

Judge Kayatta dismissed the argument, saying that the Supreme Court decided that the appeal was not moot under Article III because the impossibility of granting any effectual relief had not been shown. Cofina's appeal, he said, did not involve Article III mootness. He conceded there was a "live controversy."

Contrasted to constitutional mootness, Judge Kayatta said that equitable mootness deals with how the court decides a controversy, "not whether we have jurisdiction to decide it." He went on to say that equitable mootness "is perhaps a misnomer."

"The doctrine might better be viewed as akin to equitable laches, the notion that the passage of time and inaction by a party can render relief inequitable," Judge Kayatta said. He went on to justify equitable mootness as a reflection of the bankruptcy court's inherently equitable powers, as shown in venerable Supreme Court decisions such as *Pepper v. Litton*, 308 U.S. 295, 304 (1939).

Having established the viability of equitable mootness, Judge Kayatta needed little more than two pages to rule that the doctrine applies in PROMESA cases. "Nothing in PROMESA undercuts the inherently equitable nature of a proceeding to approve a plan of adjustment," he said.

'They Sat on Their Hands'

With equitable mootness alive and well, Judge Kayatta applied the facts to the law. The appellants, he said, "sat on their hands" by never seeking a stay pending appeal. Their "complete and repeated lack of diligence . . . cuts sharply against them," he said.

Regarding the feasibility of granting the appellants any relief, Judge Kayatta said they "offer no practical way to undo all of this and return to the pre-confirmation status quo."

Judge Kayatta recognized "that, in some cases, it might be possible to modify a stand-alone component of a plan to satisfy an idiosyncratic claim without upsetting the interests of third parties." However, he said that the appellants offered "no relevant stand-alone component [of the plan] that might be modified."

Judge Kayatta dismissed the appeal as equitably moot.

The PG&E Appeal

PG&E, a California utility, confirmed and immediately consummated a chapter 11 plan in July 2020. Among other things, effectuating the plan entailed establishing a $13.5 billion fund for fire victims, creating an $11 billion trust, making $42 billion in disbursements, and issuing new stock plus billions of dollars in debt.

Some creditors objected to the plan and appealed. They objected to provisions in the plan requiring them to exhaust their own insurance coverage before turning to the plan for payment.

The plan had been consummated, District Judge Haywood S. Gilliam, Jr. said, and the appellants offered no "adequate explanation" for failing to pursue a stay pending appeal.

Judge Gilliam could fathom no relief he might grant were he to reverse. Other creditors would be harmed, he said, because they would receive less if the appellants were no longer required to exhaust their own insurance coverage.

Judge Gilliam dismissed the appeal as equitably moot on February 8.

The opinions are *Pinto-Lugo v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 987 F.3d 173 (1st Cir. Feb. 8, 2021); and *Paradise Unified School District v. Fire Victim Trust*, 20-05414, 2021 BL 43249 (N.D. Cal. Feb. 8, 2021).

Circuit says that some factors are more important than others when applying equitable mootness to appeals from liquidating plans.

Tenth Circuit Applies Equitable Mootness to Appeals from Liquidating Chapter 11 Plans

The Tenth Circuit held that the doctrine of equitable mootness applies to appeals from confirmation of liquidating chapter 11 plans, not just conventional reorganizations.

Although the doctrine applies, some factors are more important when the plan is a liquidation, the appeals court said.

The debtor owned a plant that filed a chapter 11 petition in Kansas. An affiliate had provided millions in financing. The affiliate was in its own chapter 11 case in Missouri.

Over the affiliate's objection, the trustee for the Kansas debtor confirmed a liquidating chapter 11 plan that subordinated the affiliate's claim to the claims of all other creditors. The plan meant that the affiliate would receive nothing.

The affiliate appealed and unsuccessfully sought a stay pending appeal. The district court dismissed the appeal for equitable mootness. The affiliate appealed again to the Tenth Circuit.

Applying abuse of discretion as the standard of review, the Tenth Circuit dismissed the appeal for equitable mootness in an opinion on May 5 by Circuit Judge Timothy M. Tymkovich.

The affiliated wanted the appeals court to rule as a matter of law that equitable mootness does not apply to cash-only liquidations in chapter 11. The circuit court declined the invitation.

Judge Tymkovich characterized equitable mootness as "a judicially-created doctrine of abstention" arising from the "practical concern" that overturning confirmed plans "might disrupt the confirmed plan or otherwise harm the interests of third parties who have justifiably relied upon plan confirmation." He observed that every circuit, including the Tenth, "has adopted some variation of the equitable-mootness doctrine." In the Tenth Circuit, *see Search Market Direct Inc. v. Paige (In re Paige)*, 584 F.3d 1327 (10th Cir. 2009).

Judge Tymkovich noted how some judges and academics have criticized equitable mootness. Since the Supreme Court has not addressed the issue, he said the Tenth Circuit would continue to "apply" *Paige*.

Judge Tymkovich declined to "erect a categorical bar" to application of equitable mootness to liquidating plans. In fact, he saw "no reason" to treat a liquidating plan "any differently than a more conventional plan of reorganization." He also recognized that the Second and Fifth Circuits have applied equitable mootness to liquidating plans.

Nonetheless, Judge Tymkovich said that three of the five factors laid down by *Paige* "permit courts to consider the specific attributes of a confirmed plan of liquidation." He was referring to the effect on innocent third parties, public policy needs, and, "most especially," the impact on reorganization.

Having rejected the appellant's categorical bar, Judge Tymkovich proceeded to apply the *Paige* factors to the case on appeal and upheld dismissal of the appeal as equitably moot.

The opinion is *Drivetrain LLC v. Kozel (In re Abengoa Bioenergy Biomass of Kansas LLC)*, 18-3120 (10th Cir. May 5, 2020).

Creditors are entitled to 'default interest' when the debtor is solvent.

Judge Isgur Sides with the Third Circuit and Allows Makewhole Premiums

In a masterful opinion, Bankruptcy Judge Marvin Isgur of Houston answered two questions assigned to him by the Fifth Circuit. He held that (1) creditors of a solvent debtor are entitled to payment of a so-called makewhole, and (2) the solvent-debtor exception survived adoption of the Bankruptcy Code and allows affected creditors to recover interest at the higher default rate.

Although the case involved a "massively solvent" debtor, the analysis in Judge Isgur's October 26 opinion would seem to allow makewhole claims even if the debtor is insolvent.

The circuits are split on the allowance of makewholes. The Third Circuit allowed makewholes in *Delaware Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 842 F.3d 247 (3d Cir. 2016), but the Second Circuit seemingly disallowed makewholes in *BOKF NA v. Momentive Performance Materials Inc. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. 2017), *cert. den. sub nom BOKF N.A. v. Momentive Performance Materials Inc.*, 138 S. Ct. 2653 (2018).

Judge Isgur said that the Second Circuit's *MPM* opinion was *dicta* to the extent it appeared to say that makewholes are disallowed. For some of ABI's coverage of *Energy Future* and *MPM*, click here and here.

Plan Doesn't Pay Makewholes and Default Interest

Oil and gas producers, the debtors in Judge Isgur's case were forced into chapter 11 in 2016 when the price of petroleum collapsed. Insolvent on filing, Judge Isgur said they became "massively solvent" when the price of oil rose. The debtors proposed a plan where all classes of creditors were unimpaired.

The bondholders' loan agreement included a so-called makewhole premium. A makewhole compensates a lender for being forced to reinvest at lower interest rates if the loan is paid before maturity. The debtors did not propose to pay the makewhole, contending that the makewhole would be unmatured interest disallowed under Section 502(b)(2).

The loan agreements for both the bondholders and the revolving credit lenders called for interest after default about 2 percentage points above the contract rate. The plan, however,

proposed to pay post-petition interest at the federal judgment rate, not at the higher default rate imposed by the loan agreements.

Noteholders and revolving credit lenders objected to the plan. To permit confirmation, the debtors set aside almost $400 million to compensate the bondholders and the revolving credit lenders if their claims for the makewhole and default rate must be paid to render their claims unimpaired.

Skipping over some of the appellate history, the Fifth Circuit held in November 2019 that disallowing the makewhole and default interest under provisions of the Bankruptcy Code by itself did not render the claims impaired. *Ultra Petroleum Corp. v. Ad Hoc Committee of Unsecured Creditors (In re Ultra Petroleum Corp.)*, 943 F.3d 758 (5th Cir. Nov. 26, 2019). To read ABI's report, click here.

In a decision that was on appeal, Judge Isgur had not ruled on whether default interest or the makewhole were disallowed by Section 502(b)(2). The circuit court said that Judge Isgur was "best able" to rule in the first instance on the allowance of makewholes and default interest. *Id*. at 765. Nonetheless, the appeals court went on to say, "Our review of the record reveals no reason why the solvent-debtor exception could not apply." *Id.*

Makewholes Are Allowed

With regard to the two questions given to Judge Isgur on remand, the result turned the interpretation of Section 502(b)(2), which disallows a claim for "unmatured interest."

Although unmatured interest is not defined by the Code, Judge Isgur said that interest is "widely understood as consideration for the use or forbearance of another's money accruing over time." The question therefore required Judge Isgur to decide whether a makewhole is unmatured interest.

First, Judge Isgur said that a makewhole is enforceable under New York law, the parties' choice of law. Next, he analyzed whether a makewhole is interest or unmatured interest.

Judge Isgur said that unmatured interest "is interest that has not accrued or been earned as of a reference date," or "compensation for the future use of another's money."

Judge Isgur concluded that a makewhole is neither interest nor unmatured interest because it does not compensate the bondholders for the use or forbearance of the use of money. Rather, he said, it compensates the bondholders for a "breach of a promise to use money" or "the cost of reinvesting in a less favorable market."

Likewise, a makewhole is not the economic equivalent of unmatured interest and is distinguishable from original issue discount. Furthermore, Judge Igur said that a makewhole is "not an example of clever attorneys drafting around the provisions of Section 502."

Judge Isgur analyzed the Second Circuit's *MPM* decision. He said the New York-based appeals court "was not presented with the question of whether a makewhole is unmatured interest." Any statement about the characterization of a makewhole "was *dicta*," he said.

Because a makewhole is "not interest [and] also not unmatured interest," Judge Isgur held that the makewhole "forms part of the Note Holders' allowed claims."

The Solvent-Debtor Exception

The allowance or disallowance of the default rates of interest turned on the survival of the solvent-debtor exception and its 300 years of history under English and U.S. law.

Following adoption of the Bankruptcy Act of 1898, the Supreme Court said that fundamental principles of English law carried over into U.S. bankruptcy law. One of those principles was the disallowance of interest after the filing date, as codified in Section 63 of the Bankruptcy Act.

Nonetheless, Judge Isgur said that courts "consistently" applied the solvent-debtor exception in cases under the Bankruptcy Act. The exception means that creditors are entitled to post-petition interest when the debtor is solvent.

Because the treatment of unmatured interest in Section 502(b)(2) of the Code was "nearly identical" to Section 63 of the Act, Judge Isgur cited the Fifth, First and Sixth Circuits for holding that the solvent-debtor exception was not abrogated by adoption of the Bankruptcy Code. Neither the statute nor its legislative history shows "clear Congressional intent" to dispense with the exception, Judge Isgur said.

Furthermore, Judge Isgur said, "[e]quitable considerations support the solvent-debtor exception." It ensures "that the debtor does not receive a windfall at the expense of its creditors."

Deciding that the creditors were entitled to post-petition interest left open the question of rate. The debtors opted for the federal judgment rate, but the creditors wanted the higher default rates prescribed by the loan agreements.

If the creditors only received the judgment rate, they would be "worse off" under the plan than impaired creditors. "Additionally," Judge Isgur said, imposing the federal judgment rate would "contravene[] the purpose of the solvent-debtor exception."

Judge Isgur allowed the claims for default interest, saying he would "not upset three hundred years of established law."

Observations

Reading like a treatise, Judge Isgur's opinion is the most comprehensive analysis so far of the nature of makewholes. In the Second Circuit, where makewholes were seemingly disallowed by *MPM*, his opinion opens the door for lower courts to follow the Third Circuit by saying the Second Circuit's comments were *dicta* on allowance of a makewhole.

If the Fifth Circuit affirms Judge Isgur, there may be a petition for *certiorari*, but the Supreme Court declined to review *MPM*. Judge Isgur's opinion could diminish the probability of "grant" because there is no circuit split, if he was correct in saying that the Second Circuit's statements about makewhole were *dicta*.

There is an opening, however, for a different result. Appellate courts, especially those not steeped in the lore of bankruptcy law, are increasingly prone to follow what they perceive as the plain language of the statute.

Section 502(b)(2) is a blanket disallowance of unmatured interest. There is no hint about a solvent-debtor exception in its plain language. A court might say that Congress could have engrafted the exception onto the statute if it intended to do so.

Judge Isgur went to great pains to explain why a makewhole is not unmatured interest. Another court, however, might view a makewhole as interest that the lenders did not or will not receive.

The Supreme Court is drawing away from cases like *Dewsnup*, where the justices followed decisional law under the Bankruptcy Act by arguably disregarding Sections 506(a) and 506(d) to preclude a debtor from stripping down an undersecured mortgage. *Dewsnup v. Timm*, 502 U.S. 410 (1992).

The late Justice Antonin Scalia wrote a vigorous dissent in *Dewsnup*, accusing the majority of ignoring the plain language of the statute by adopting a policy contrary to decisions that Congress made by enacting the Bankruptcy Code.

Twenty-three years later, the justices seemed primed to revisit *Dewsnup*. At oral argument in *Bank of America N.A. v. Caulkett*, 135 S. Ct. 1995 (2015), several justices apparently thought *Dewsnup* was wrongly decided. Indeed, the unanimous opinion in *Caulkett*, written by Justice Clarence Thomas, said that a "straightforward reading of the statute" would allow a debtor to strip off an underwater mortgage.

The justices were given the opportunity to overrule *Dewsnup*, but the Court denied *certiorari* in *Ritter v. Brady*, 139 S. Ct. 1186, 203 L. Ed. 2d 256 (2019).

If the makewhole issue ever reaches the Supreme Court, the result may turn on how much the justices do or do not read into Section 502(b)(2).

Will the Supreme Court recognize the solvent-debtor exception just like it followed pre-Code law in *Dewsnup*? Or, will the Court refuse to look beyond Section 502(b)(2) and rule that the exception did not survive adoption of the Code?

For makewholes, there could be a middle ground. Some courts might allow them for solvent debtors but disallow them when the debtors are insolvent. The issue will test the reservoir of equitable powers that remain in bankruptcy courts.

The opinion is *In re Ultra Petroleum Corp.*, 16-322032, 2020 BL 413677 (Bankr. S.D. Tex. Oct, 26, 2020).

Stays & Injunctions

Aligning with the Third Circuit, the Ninth Circuit says that lower courts were reading its prior decisions too broadly.

Ninth Circuit Now Permits Nonconsensual, Third-Party Releases in Chapter 11 Plans

The Ninth Circuit had been generally understood as categorically banning nonconsensual, third-party releases in chapter 11 plans.

Narrowing, if not repudiating, three earlier opinions in a published decision on June 11, the Ninth Circuit explicitly aligned itself with the Third Circuit by permitting nonconsensual, third-party releases in chapter 11 plans that exculpate participants in the reorganization from claims based on actions taken during the case.

In her opinion for the appeals court, Ninth Circuit Judge Marsha S. Berzon quoted the Third Circuit for observing that "similar limited exculpatory clauses focused on acts committed as part of the bankruptcy proceedings are 'apparently a commonplace provision in Chapter 11 plans,'" citing *PWS Holding Corp.*, 228 F.3d 224, 245 (3d Cir. 2000).

The Circuit Split

The Fifth, Ninth and Tenth Circuits were commonly understood as prohibiting nonconsensual, third-party releases in chapter 11 plans, while the Second, Third, Fourth, Sixth and Eleventh Circuits permit exculpations in "rare" or "unusual" cases.

Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.), 584 F.3d 229, 251 (5th Cir. 2009), represents the Fifth Circuit's prohibition of third-party releases in chapter 11 plans. On the other side of the fence, the Second Circuit has said that releases of the type are proper, but only when "a particular release is essential and integral to the reorganization itself." *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 141-43 (2d Cir. 2005).

There was good reason for believing the ban on third-party releases was categorical in the Ninth Circuit. In *In re Lowenschuss*, 67 F.3d 1394, 1401-1402 (9th Cir. 1995), the Ninth Circuit held, "without exception, that Section 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors," unless the case falls within Section 524(g) pertaining to asbestos claims.

For example, a district judge in Washington State criticized several lower court opinions in the Ninth Circuit that, in his view, violated the hard-and-fast rule laid down by *Lowenschuss*. The judge refused to recognize any loopholes in the Ninth Circuit's categorical ban on nondebtor, third-

party releases in *In re Fraser's Boiler Service Inc.*, 18-05637, 2019 BL 80048, 2019 U.S. Dist. Lexis 37840, 2019 WL 1099713 (W.D. Wash. March 8, 2019). To read ABI's report on *Fraser's*, click here.

Tim Blixseth Changes the Law (but Still Loses)

And then came Timothy Blixseth and the seemingly unending litigation in the wake of the chapter 11 reorganization and sale of his Yellowstone Mountain Club LLC. Ultimately, the club was sold to a third party over Blixseth's objection as part of a chapter 11 plan.

The plan contained a release in favor of specified nondebtor third parties, including the club's primary bank lender. The provision read as follows:

> None of [the exculpated parties, including the bank], shall have or incur any liability to any Person for any act or omission in connection with, relating to or arising out of the Chapter 11 Cases, the formulation, negotiation, implementation, confirmation or consummation of this Plan, the Disclosure Statement, or any contract, instrument, release or other agreement or document entered into during the Chapter 11 Cases or otherwise created in connection with this Plan . . . .

The release did not forgive "willful misconduct or gross negligence."

Challenging the releases, Blixseth was originally appealing confirmation of the plan as to third parties, as well as to the bank. Because the other third parties settled, Blixseth went forward with his appeal only as to the bank.

Having previously ruled that the appeal was not equitably moot because the court might be able to fashion some form of relief, Judge Berzon tackled the propriety of third-party releases.

The Circuit Narrows Its Precedents

Quoting the bankruptcy court, Judge Berzon said that the releases were "'narrow both in scope and time'" and were limited to acts and omissions "'in connection with, relating to or arising out of the Chapter 11 cases.'" She also cited the bankruptcy court's finding that the releases only covered those who were "'closely involved'" in formulating the plan.

Judge Berzon noted the bankruptcy court's finding that the exculpation was "not 'a broad sweeping provision that seeks to discharge or release nondebtors from any and all claims that belong to others.'"

Recognizing the "long-running circuit split," Judge Berzon cited the governing statute, Section 524(e), which provides that "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." She held that the section "does not bar a narrow exculpation clause of the kind here at issue — that is, one focused on actions of various participants in the Plan approval process and relating only to that process."

Focusing on the language of Section 524(e) rather than the court's previous perception of a larger policy, Judge Berzon quoted the *Collier* treatise for saying that "'discharge in no way affects the liability of any other entity . . . for the *discharged* debt.'" [Emphasis in original.]

After noting the narrow prohibition in Section 524(e), Judge Berzon dealt with Blixseth's reliance on three Ninth Circuit opinions with seemingly broad rejections of third-party releases. She said those cases "all involved sweeping nondebtor releases from creditors' claims on the debts discharged in the bankruptcy, not releases of participants in the plan development and approval process for actions taken during those processes."

Having distinguished prior Ninth Circuit authority, Judge Berzon said that Section 105(a) gave the bankruptcy court "authority to approve an exculpation clause intended to trim subsequent litigation over acts taken during the bankruptcy proceedings and so render the Plan viable."

Recognizing that the Fifth Circuit in *Pacific Lumber* "reached a conclusion opposite ours," Judge Berzon ruled that Section 524(e) did not bar the exculpation, because it "covers only liabilities arising from the bankruptcy proceedings and not the discharged debt."

Question

Will large companies now consider reorganizing in the Ninth Circuit, given that exculpations are feasible? (I'm not holding my breath.)

The opinion is *Blixseth v. Credit Suisse*, 16-35304 (9th Cir. June 11, 2020).

A subordinate lender lacked appellate standing to appeal the annulment of the automatic stay in favor of a senior lender.

Creditors Lack Standing to Enforce the Automatic Stay in the Ninth Circuit

A subordinate secured lender did not have appellate standing to challenge the bankruptcy court's annulment of the automatic stay in favor of a senior lender, even though it meant the subordinate lender's lien was extinguished, the Ninth Circuit held.

In a perfect world, it might have been preferable to pour out the subordinate lender on the ground of *laches*, but the Ninth Circuit panel based its decision on circuit authority, which says that a creditor lacks standing to appeal an order finding no violation of the automatic stay.

In the case on appeal, enforcing the automatic stay would have conferred benefit only on the subordinate lender, not on creditors generally. The opinion may not mean that creditors are always out of luck when the debtor or trustee is asleep at the switch.

Foreclosure Violates the Automatic Stay

The Ninth Circuit's nonprecedential, *per curiam* opinion on October 28 only contains a cursory statement of the facts.

The record indicates that the couple purchased their home in 2005 and filed a chapter 7 petition in 2008. They received their discharges in 2010. While the case was pending, and without notice to anyone, the homeowners' association filed a notice of delinquency giving rise to a lien having priority under California law over the lien of the $1.4 million mortgage.

After discharge, but while the case was still pending, and again without notice to anyone, the homeowners' association conducted and completed a foreclosure sale, taking title to the property and ostensibly extinguishing the mortgage.

Four years after the bankruptcy case was closed and nine years after discharge, the mortgage lender reopened the case and filed a motion seeking a declaration that the foreclosure sale violated the automatic stay and was void. The homeowners' association countered with a motion of its own to annul the automatic stay.

No Standing to Enforce the Stay

The bankruptcy court recognized there was a willful stay violation, meaning that the foreclosure sale was void. The bankruptcy judge nevertheless found cause for annulling the automatic stay, that is, retroactively modifying the automatic stay to validate the foreclosure. The bankruptcy court recognized the "extreme consequence" of annulling the stay, because it meant the mortgage was extinguished.

The mortgage lender appealed, but the Bankruptcy Appellate Panel dismissed the appeal for lack of appellate standing. The panel of the Ninth Circuit agreed.

The result turned on *Tilley v. Vucurevich* (*In re Pecan Groves of Ariz.*), 951 F.2d 242, 245 (9th Cir. 1991), where the Ninth Circuit held that "a creditor has no independent standing to appeal an adverse decision regarding a violation of the automatic stay."

The mortgage lender argued, unsuccessfully, that the automatic stay protects both debtors and creditors.

The panel of the Ninth Circuit disagreed, interpreting *Pecan Groves* to mean "that the automatic stay is not intended to benefit individual creditors." Consequently, the panel said that the mortgage lender was not a "person aggrieved" because it was not "directly and adversely affected pecuniarily," citing *Harkey v. Grobstein* (*In re Point Ctr. Fin., Inc.*), 890 F.3d 1188, 1191 (9th Cir. 2018). To read ABI's report on *Point Center*, click here.

Since the automatic stay "is not intended to benefit individual creditors," the Ninth Circuit panel dismissed the appeal because the mortgage lender lacked appellate standing. Stating the result more fully, the panel said that the lender did "not have standing to enforce the automatic stay against other creditors, to oppose the motion for retroactive annulment of the automatic stay, or to appeal the bankruptcy court's grant of the retroactive annulment motion."

Observations

Taking *Pecan Groves* at face value, creditors aren't necessarily out of luck if a debtor or trustee declines to enforce the automatic stay, to the detriment of creditors generally.

A creditor could file a motion seeking derivative standing to enforce the stay on behalf of the estate, just like creditors or committees can be authorized to file a lawsuit if the debtor ignores a demand to pursue a meritorious claim.

In the case on appeal, the debtors purchased their home in 2005 and evidently fell behind on the mortgage following the crash in the housing market. Presumably, there was no equity in the home and thus no reason to enforce the automatic stay for the benefit of creditors generally.

Furthermore, the mortgage lender could have protected its rights by paying the fees owing to the homeowners' association or foreclosing its own mortgage.

In short, the facts did not present a case for allowing one creditor to enforce the stay for its benefit alone.

The opinion is *Bank of New York Mellon v. 2298 Driftwood Tide Trust (In re Barrett)*, 19-60043, 2020 BL 416716 (9th Cir. Oct. 28, 2020).

Ninth Circuit abjures bright lines in favor of a flexible approach to defining recoupment.

Ninth Circuit Reiterates Its Idiosyncratic Recoupment Standard

A panel of the Ninth Circuit needed 11 months to write an opinion applying the appeals court's indistinct standard differentiating setoff from recoupment. Where the circuit's flexible standard largely favors creditors, the new opinion moves the bar ever so slightly in favor of debtors.

Recoupment is a judge-made equitable doctrine lacking some of the strictures of setoff. Under Section 362(a)(7), setoff is subject to the automatic stay, and Section 553 has a list of circumstances when setoff is not enforceable.

In general terms, Section 553 allows a creditor to offset mutual debts and credits that arose before bankruptcy. As Circuit Judge Daniel P. Collins explained in his September 16 opinion, setoff allows a creditor to net out debts and claims arising from different transactions, so long as they were mutual and arose before bankruptcy. Furthermore, mutuality is strictly construed.

Originating as a pleading concept before the advent of the Federal Rules of Civil Procedure, recoupment appears nowhere in the statute. Contrasted to setoff, recoupment requires that the debts and credits must have arisen from the same transaction or occurrence. The two leading Ninth Circuit recoupment cases tell us that "recoupment is often thought not to be subject to the automatic stay" and "may be employed across the petition date." *Newbery Corp. v. Fireman's Fund Ins. Co.*, 95 F.3d 1392, 1399 (9th Cir. 1996); and *Sims v. U.S. Dep't of Health & Human Servs. (In re TLC Hosps., Inc.)*, 224 F.3d 1008, 1011 (9th Cir. 2000).

Unlike the Third Circuit, which applies a narrow definition to "transaction," Judge Collins explained that *Newbery* and *Sims* only require a "logical relationship" between the transactions or occurrences, thus giving a "flexible meaning" to the same-transaction requirement." *Sims, id.*, at 1012; *Newbery, id*., at 1402.

Furthermore, the Ninth Circuit rejected the Third Circuit's requirement of a temporal proximity between the transactions, Judge Collins said.

The case on appeal did not entail an easy application of the Ninth Circuit's flexible standard.

The debtor was a hospital where the State of California was asserting the right to recoup Medicaid payments owing to the hospital against fees that the hospital owed to the state. Upheld by the Bankruptcy Appellate Panel, the bankruptcy court allowed the state's recoupment in full.

Judge Collins upheld the lower courts in part, reversed in part and remanded.

Applying *Sims* and *Newbery*, Judge Collins held that the state was entitled to recoup payments coming from a specified state fund against payments the hospital owed to the same fund. However, he reversed the lower courts by holding that the state only had a right to offset payments the hospital owed to the fund against ordinary Medicaid payments that did not come from the fund.

Judge Collins ended his opinion with a holding that may have application in other circuits.

The state argued it was entitled to offset everything owing to the hospital because state law specifically allowed the state to deduct payments owing by a hospital to the fund against Medicaid payments owing to the hospital.

Judge Collins rejected the state's argument, saying it "would effectively obliterate the distinction between recoupment and setoff and thereby exempt California entirely from the Bankruptcy Code's restrictions on setoff."

Observations

The appeals court's difficulty in applying the circuit's squishy recoupment standard shows the virtue of bright-line rules. Although bright lines sometimes result in seemingly inequitable outcomes, bright lines are easier for courts to apply and for parties to anticipate the outcome.

As a judge-made doctrine nowhere sanctioned by statute, this writer submits that recoupment should be narrowly construed to avoid transgressing fundamental principles underlying the Bankruptcy Code.

The opinion is *Gardens Regional Hospital & Medical Center Liquidating Trust v. California (In re Gardens Regional Hospital & Medical Center Liquidating Trust)*, 18-60016 (9th Cir. Sept. 16, 2020).

Section 365(d)(3) doesn't contain a remedy for failure to pay rent on time, Judge Huennekens says.

Statutory Basis Explained for Deferring Rent in Response to the Coronavirus

In the reorganization of retailer Pier I Imports Inc., Bankruptcy Judge Kevin R. Huennekens explained the statutory basis for his decision to "defer" rent temporarily during the coronavirus pandemic.

With the stores closed, Judge Huennekens is allowing the debtors to skip rent for April and May, although Section 365(d)(3) ostensibly requires "timely" payment. Unless the judge extends the moratorium, the debtors will begin paying rent in June and have promised to cure arrears by the middle of July.

In his May 10 opinion, Judge Huennekens said there is "no feasible alternative." Among all the creditors, the only objection came from a group of landlords. The judge said they "are merely one group among many that must make concessions in order to benefit all."

The Disruption of the Business

Pier I filed a chapter 11 petition on February 17 and expected to confirm a plan in 60 days. At the time, the debtors were expecting only temporary disruptions in the supply of inventory from China. As it turned out, of course, the debtors were later compelled to shutter all stores. Revenue "dried up overnight," Judge Huennekens said.

The debtors filed a motion on March 31 asking Judge Huennekens for permission to defer everything except essential payments. The judge granted the relief on a temporary basis on April 6 and held another hearing on April 28.

Judge Huennekens extended the moratorium until May 31 by order dated May 5. He filed his May 10 opinion to explain the legal basis for the relief. Of significance for landlords, the debtors must continue to pay for insurance, utilities, and security systems.

Some landlords objected to rent deferral, but Judge Huennekens said that "each of the substantive objections raised by the Lessors fails."

Judge Huennekens was careful to say he "did not find that the Debtors do not have to pay rent," nor did he decide that performance was excused by "impossibility, impracticability, or frustration

of purpose.

Section 365(d)(3) Doesn't Compel Payment

Turning to the Bankruptcy Code, Judge Huennekens interpreted Section 365(d)(3) to mean that the debtors have "an obligation to pay rent in accordance with the terms of the underlying leases." However, the section does not contain "a remedy to effect payment," Judge Huennekens said, referring to his own authority in *In re Circuit City Stores Inc.*, 447 B.R. 475, 511 (Bankr. E.D. Va. 2009).

Instead, *Circuit City* said that a landlord has an administrative expense claim if rent is not paid, "not a claim entitled to superpriority." *Id.* In turn, administrative claims must be paid in cash on the effective date of the plan under Section 1129(a)(9)(A).

If he were to compel payment now, Judge Huennekens said he would be elevating payment of rent to superpriority status. "The Lessors are not entitled to such relief," he said.

The landlords nevertheless might be entitled to adequate protection under Sections 361 and 363. If the landlords had a right to adequate protection (and the opinion doesn't seem to say they did), Judge Huennekens said that current payments for insurance, utilities and security coupled with "assurance of cure payments in July is sufficient to protect the Lessors against any perceived diminution in value."

Extending rent deferral at least until May 31, Judge Huennekens said that the debtors "cannot operate as a going concern and produce the revenue necessary to pay rent because they have been ordered to close their business."

The opinion is *In re Pier I Imports Inc.*, 20-30805 (Bankr. E.D. Va. May 10, 2020).

Retroactive and nunc pro tunc orders aren't the same thing, Judge Jaime says. Orders may be retroactive when the power is implied by statute.

California Judge Explains Why *Acevedo* Doesn't Bar Retroactive Orders

In *Acevedo*, the Supreme Court banned *nunc pro tunc* orders as they were often used by bankruptcy courts. Bankruptcy Judge Christopher D. Jaime of Sacramento, Calif., explained why *Acevedo* did not bar bankruptcy courts from granting retroactive relief.

What *Acevedo* Did and Didn't Do

Handed down in February, *Acevedo* was a *per curiam* opinion that strictly limited the ability of federal courts to enter orders *nunc pro tunc*. *Roman Catholic Archdiocese of San Juan, Puerto Rico v. Acevedo Feliciano*, 140 S. Ct. 696 (2020).

Quoting one of its prior decisions, the Court said that a *nunc pro tunc* order must "'reflect[] the reality'" of what has occurred. A *nunc pro tunc* order, the Court said, "presupposes" that a court has made a decree that was not entered on account of "inadvertence." *Id.* at 700-701.

As Judge Jaime said in his October 13 opinion, *Acevedo* "effectively ends federal courts' use of *nunc pro tunc* orders to the extent such orders rewrite history to retroactively make the record reflect something that never occurred in the first instance." Those orders, he said, "have been common, particularly with respect to employment under Section 327."

The high court "has necessitated a change in bankruptcy practice," Judge Jaime said. To read ABI's report on *Acevedo*, click here.

The Case Before Judge Jaime

In 2013, an elderly woman signed a contingency fee agreement for counsel to prosecute her personal injury claim in a class action involving an implanted medical device. At age 87 in 2017, she filed a chapter 7 petition and received a discharge in her "no asset" case. The debtor said she had forgotten about the personal injury claim and scheduled neither the claim nor the contingency arrangement.

Two years after bankruptcy, the debtor received an offer to settle the claim for $165,000. The court reopened the bankruptcy, and creditors filed claims for almost $33,000. The chapter 7 trustee

later filed a motion to approve settlement of the claim, retain the lawyer *nunc pro tunc* as special counsel on the contingency agreement, and pay special counsel's fee.

If all were approved, the lawyer would be paid almost $64,000, the debtor would have a $30,000 exemption in the proceeds, creditors and administrative claims would be paid in full, and the debtor would have a small surplus.

Retroactive Relief Is Ok; *Nunc Pro Tunc* Isn't

Clearly, the trustee was not entitled to have the court retain special counsel *nunc pro tunc* as the foundation for paying the contingency fee. However, Judge Jaime said that *Acevedo* is "not a *per se* prohibition of all retroactive relief in all instances." He went on to say that "[s]tatutes may also serve as a basis, express or implied, for orders that have retroactive effect without need for inherent power *nunc pro tunc* orders."

For example, Judge Jaime said that the Bankruptcy Code contains express authority for a retroactive order in Section 362(d) by giving the court the ability to annul the automatic stay. Implied authority for retroactive orders resides in provisions "that do not mandate that such approval actually precede the statutory activity."

Judge Jaime cited a Ninth Circuit opinion saying that postpetition financing could be approved under Section 364(c)(2) even if the loan had been made before entry of the financing order. *Sherman v. Harbin (In re Harbin)*, 486 F.3d 510 (9th Cir. 2007). He cited a second Ninth Circuit opinion allowing retroactive approval of compensation for a professional's unauthorized services. *Atkins v. Wain Samuel & Co.*, 69 F.3d 970 (9th Cir. 1995).

Although a retention order is a prerequisite to the allowance of compensation, Judge Jaime said "there is no requirement that compensated services must have been performed only after the effective date of an employment order." He therefore held that "the power to award pre-employment compensation remains unchanged" because the two circuit decisions were not overruled by *Acevedo*.

The debtor was an octogenarian, so Judge Jaime said that forgetting about the claim was "plausible." He also said that counsel provided a "tremendous benefit" to the estate, allowing payment of claims in full with a surplus for the debtor. Furthermore, the contingent fee was "reasonable value" for the special counsel's services.

Judge Jaime denied the motion for *nunc pro tunc* retention, approved retention as of the date of the retention order, and approved the special counsel's compensation.

The opinion is *In re Miller*, 17-23606, 2020 BL 394432, 2020 Bankr Lexis 2856 (Bankr. E.D. Cal. Oct. 13, 2020).

Did the Supreme Court's Acevedo opinion preclude annulling the stay? The Ninth Circuit BAP says 'no.'

Lower Courts Now Disagree on Modifying the Stay Retroactively After *Acevedo*

What a relief! The Ninth Circuit Bankruptcy Appellate Panel held that this year's *Acevedo* decision from the Supreme Court does not bar bankruptcy courts from annulling the automatic stay. Except in unusual circumstances, *Acevedo* effectively bars federal courts from entering orders *nunc pro tunc*.

To uphold the bankruptcy court, the BAP was obliged to disagree with *In re Telles*, 20-70325, 2020 WL 2121254 (Bankr. E.D.N.Y. Apr. 30, 2020). In *Telles*, a bankruptcy court on Long Island, N.Y., appeared to hold that *Acevedo* does not permit annulling the automatic stay, or modifying the stay *nunc pro tunc*, if a foreclosure sale was conducted in violation of the automatic stay. To read ABI's report on *Telles*, click here.

Filing a Lawsuit Violated the Automatic Stay

The appeal in the BAP didn't involve a foreclosure sale like *Telles*. Rather, a creditor filed a wrongful death suit against the debtor, not knowing the debtor had filed a chapter 13 petition eight months earlier.

On being told about the bankruptcy, the creditor filed a motion within a few days to annul the automatic stay.

Over the debtor's objection, Bankruptcy Judge Vincent P. Zurzolo found cause to annul the automatic stay. He allowed the creditor to liquidate its claim in state court and obtain findings that might have preclusive effect in later dischargeability litigation in bankruptcy court. However, Judge Zurzolo did not permit the creditor to enforce a judgment without further order of the bankruptcy court.

The debtor appealed and lost, in a July 13 opinion for the BAP by Bankruptcy Judge William Lafferty.

Judge Lafferty agreed there was cause to modify the automatic stay. The creditor did not have notice of the bankruptcy. The judge said there was no prejudice to the debtor aside from the fact that he had no insurance to defend the wrongful death suit. The debtor would have had the same

problem were the suit in bankruptcy court. There were other defendants in the wrongful death suit, so modifying the stay would promote judicial economy.

What Does *Acevedo* Mean for Bankruptcy?

While the appeal was pending, the Supreme Court handed down *Acevedo*. *Roman Catholic Archdiocese of San Juan, Puerto Rico v. Acevedo Feliciano*, 140 S. Ct. 696 (2020). In a *per curiam* opinion, the high court strictly limited the ability of federal courts to enter orders *nunc pro tunc*.

Quoting one of its prior decisions, the Supreme Court said that a *nunc pro tunc* order must "'reflect[] the reality'" of what has occurred. A *nunc pro tunc* order, the Court said, "presupposes" that a court has made a decree that was not entered on account of "inadvertence." *Id.* at 700-701.

In other words, the high court will allow *nunc pro tunc* orders only if the court had made a ruling but failed to enter an order at the time. To read ABI's report on *Acevedo*, click here.

Acevedo therefore raised a cloud over the ability of bankruptcy courts to annul the automatic stay or modify the stay *nunc pro tunc*. Judge Lafferty interpreted *Telles* as "prohibiting a grant of retroactive or *nunc pro tunc* relief from stay."

Judge Lafferty disagreed with *Telles*. "We do not believe that the ruling in *Acevedo* prohibits a bankruptcy court's exercise of the power to grant retroactive relief from stay," he said.

Judge Lafferty noted the statutory underpinning of the case on appeal compared to *Acevedo*. In the Supreme Court case, the federal removal statute expressly divested a state court of jurisdiction after the suit was removed.

In the case on appeal, Congress "expressly" gave power to modify the stay retroactively, Judge Lafferty said. In that regard, Section 362(d) confers power to grant relief from the stay, "such as by terminating, annulling, modifying, or conditioning such stay."

"[T]he conclusion that *Acevedo* prohibits the annulment of the stay based on jurisdiction and property of the estate concerns reads too much into the Supreme Court's opinion," Judge Lafferty said. Although he did not say so, the Supreme Court might not have the capacity to take away the ability to annul the stay, a power granted by Congress, unless there was a constitutional infirmity or lack of subject matter jurisdiction.

Judge Lafferty upheld the ruling of the bankruptcy court, saying that the "statutory language, and longstanding and sound experience, make clear that the effective use of these remedies must occasionally include the option of granting retroactive relief."

The opinion is *Merriman v. Fattorini (In re Merriman)*, 19-1245 (B.A.P. 9th Cir. July 13, 2020).

Bankruptcy Judge Grossman explores the extent to which the Supreme Court's Acevedo decision bars courts from granting relief retroactively.

May a Bankruptcy Court Annul the Automatic Stay after *Acevedo*?

In *Acevedo*, the Supreme Court ruled in February that a *nunc pro tunc* order can only memorialize an action that the court actually took at a previous time but was not officially recorded. In other words, *nunc pro tunc* cannot create the fiction of an action that the court did not actually take.

Acevedo raises this question: Are bankruptcy courts now prohibited from annulling the automatic stay?

In an opinion on April 30, Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., appeared to hold that annulling the automatic stay, or modifying the stay *nunc pro tunc*, cannot allow a state court order to stand if it was entered in violation of the automatic stay.

Good Grounds for Annulment

The facts before Judge Grossman were similar to those where courts have annulled the automatic stay: Engaged in shenanigans, the debtor filed his second chapter 13 petition two days before a scheduled foreclosure sale. Unaware of the bankruptcy filing, the lender proceeded with the sale and took title to the property.

Learning later about the bankruptcy filing, the lender filed a motion to modify the automatic stay *nunc pro tunc* to the day before the foreclosure sale.

Under law before *Acevedo*, the lender was on solid ground for obtaining an annulment of the automatic stay and giving a retroactive blessing to the foreclosure sale that was otherwise void. Judge Grossman cited authorities in his district laying out a seven-part test that would seemingly allow him to annul the stay and thereby validate the foreclosure sale.

Nonetheless, Judge Grossman denied the motion, relying on *Roman Catholic Archdiocese of San Juan v. Acevedo Feliciano*, 140 S. Ct. 696, 206, L. Ed. 2d (Feb. 24, 2020). To read ABI's report on *Acevedo*, click here.

The Lack of Jurisdiction in *Acevedo*

The facts in *Acevedo* will be critical in deciding how far the decision goes.

The defendant had removed a lawsuit from a Puerto Rico commonwealth court to federal district court based on the pendency of a bankruptcy case. Later, the bankruptcy case was dismissed, but the district court at the time did not remand the suit to the commonwealth court.

Later still, the commonwealth court assumed that its jurisdiction had been restored and entered a money judgment against the defendant. After that, the plaintiff prevailed on the district court to enter an order *nunc pro tunc* remanding the case to the commonwealth court as of the date of the dismissal of the bankruptcy.

The Supreme Court granted *certiorari* to address complex First Amendment issues. Without reaching the constitutional issues and without oral argument, the Supreme Court reversed and remanded, ruling that the Puerto Rico court was without jurisdiction to enter orders at the critical time because the suit had not been remanded when the judgment was entered.

The Supreme Court quoted one of its prior decisions to say that a *nunc pro tunc* order may "'reflect[] the reality'" of what has occurred. A *nunc pro tunc* order, the Court said, "presupposes" that a court has made a decree that was not entered on account of "inadvertence."

In other words, the high court will allow *nunc pro tunc* orders only if the court had made a ruling but failed to enter an order at the time.

In *Acevedo*, the commonwealth court was without jurisdiction when it entered a money judgment against the defendant. Because the district court had not acted, it was without power to enter an order *nunc pro tunc* remanding the case and restoring jurisdiction in the Puerto Rico court, the Supreme Court said.

Judge Grossman's Analysis

With regard to annulling the automatic stay or modifying the stay *nunc pro tunc*, Judge Grossman said the "landscape of the law is different post-*Acevedo*." The Supreme Court, he correctly said, "has clarified that *nunc pro tunc* relief cannot be used to confer jurisdiction where none existed."

After bankruptcy, Judge Grossman said, the foreclosure court in the case before him was "divested of jurisdiction . . . [and] any action taken by the state court with respect to the debtor's property is void." In other words, the foreclosure sale "was void."

Consequently, Judge Grossman concluded that "*nunc pro tunc* relief cannot be used to change the outcome of a void foreclosure sale." He therefore ruled that because "*nunc pro tunc* relief

cannot be granted to confer jurisdiction on a state court where none existed, the motion must be denied in its entirety."

The April 30 opinion is Judge Grossman's second decision dealing with *Acevedo*. In March, he held that *nunc pro tunc* retention was not required for him to grant compensation to counsel for a period of time before entry of the retention order. *In re Benitez*, 19-709230, 2020 WL 1272258, 2020 BL 95485 (Bankr. E.D.N.Y. March 13, 2020). To read ABI's report, click here.

Observations

Does *Acevedo* mean that a bankruptcy court can never grant retroactive relief or relief effective as of a date before the underlying motion was entered? Can counsel be retained as of the filing date although the motion for retention was not filed until a day or two later? May the court reject an executory contract as of the filing date if the rejection motion was not filed until days or weeks later?

And does *Acevedo* only pertain to situations where the court lacked jurisdiction? Perhaps *Acevedo* generally proscribes *nunc pro tunc* orders but does not categorically preclude an order from being effective as of an earlier date, assuming the court has jurisdiction.

In the case before Judge Grossman, did bankruptcy divest the state court of jurisdiction, or did the automatic stay only preclude the state court from taking some types of actions?

Even assuming the foreclosure sale was void on account of the automatic stay, did the state court have jurisdiction, even though its actions may have been void? If the state court was not altogether divested of jurisdiction, did the state court have sufficient jurisdiction so that its actions could be validated at a later time?

As usual, decisions by the Supreme Court raise more questions than they answer.

The opinion is *In re Telles*, 20-70325 (Bankr. E.D.N.Y. April 30, 2020).

Compensation

Dissenter in the Fifth Circuit believes that having both U.S. Trustees and bankruptcy administrators violates the Uniformity Clause.

Fifth Circuit Upholds Constitutionality of Increase in U.S. Trustee Fees

Siding with the majority of lower courts around the country, the Fifth Circuit upheld the constitutionality of the 2017 increase in fees paid by chapter 11 debtors to the U.S. Trustee Program.

Circuit Judge Edith Brown Clement dissented. Notably, she believes that the "permanent division of the country into [U.S. Trustee] districts and [bankruptcy administrator] districts violates the Bankruptcy Clause." Rather than overturn the dual U.S. Trustee/bankruptcy administrator system, she would have limited the remedy by allowing the debtor to pay the fees in effect before the increase came into effect.

The dissent raises the question of whether someone will cite the dissent and mount a headlong challenge to the constitutionality of the dual systems.

The U.S. Trustee Fee Increase

To ensure that taxpayers do not finance the U.S. Trustee Program, Congress revised the U.S. Trustee fees as part of the Bankruptcy Judgeship Act of 2017. Codified at 27 U.S.C. § 1930(a)(6)(B), the fee increases whenever the balance in the U.S. Trustee System Fund falls below $200 million at the end of any fiscal year through 2022.

Since the fund balance was below the threshold, the fee increased as of Oct. 27, 2017, when the amendment became effective. With the increase, "the quarterly fee payable for a quarter in which disbursements equal or exceed $1,000,000 shall be the lesser of 1 percent of such disbursements or $250,000."

If the debtor disburses $1 million a quarter, the increased quarterly fee is $10,000, or $40,000 a year. Under the prior fee schedule, the quarterly fee would have been $4,785 if disbursements were $999,999 in the quarter, or $6,500 if the quarterly disbursements were $1 million but less than $2 million.

If quarterly disbursements are $25 million or more, the fee is now $250,000 a quarter. At $25 million under the old schedule, the fee would have been $20,000 a quarter. For a company with $25 million in quarterly disbursements, the fee rose by 1,250%

The word "disbursements" is not defined in the statute.

The increase hits middle-market companies, because the fees for large companies in chapter 11 are capped at $250,000 a quarter. The increase is tough on companies with low margins but high sales volumes.

In February 2019, Bankruptcy Judge Ronald B. King of San Antonio ruled that the increase in fees does not apply to pending cases because the amended statute, 27 U.S.C. § 1930(a)(6)(B), is not retroactive. He went on to hold that the statute violates the Bankruptcy, Uniformity, and Due Process Clauses of the Constitution. *In re Buffets LLC*, 597 B.R. 588 (Bankr. W.D. Tex. 2019). To read ABI's discussion of *Buffets*, click here.

The Fifth Circuit accepted a direct appeal from the decision by Judge King.

The Majority Reverse Judge King

Writing for himself and Circuit Judge Carl E. Stewart, Circuit Judge Gregg Costa noted that a majority of bankruptcy courts have found the increase to be constitutional. He agreed with the majority and found the increase to be applicable to the debtor whose chapter 11 plan had been confirmed before the increase came into effect.

The gravamen of the debtor's argument was based on the six districts in Alabama and North Carolina that Congress allowed to continue using bankruptcy administrators in lieu of the U.S. Trustee program. In those districts, the fees are set by the Judicial Conference of the U.S.

The Judicial Conference raised the fees for the bankruptcy administrators, but the increase was only applicable to cases filed on or after October 1, 2018. In the case on appeal to the Fifth Circuit, the debtor confirmed its plan in 2017. The U.S. Trustee took the position that the increase applied to the debtor because its case was still pending when the increase came into effect.

Bankruptcy Judge King sided with the debtor, but the majority on the circuit panel didn't.

Judge Costa first ruled that all of the debtor's expenditures were classified as "disbursements," including routine operating expenses.

Next, Judge Costa decided that the increase applied even though the debtor's case was pending when the increase came into effect. He ruled that the "applicability of the new fee thus turns on

when debtors make disbursements, not when their cases are filed or confirmed." Based on "statutory history," he said that "new disbursements, not new cases, trigger the higher fees."

Similarly, Judge Costa concluded that the increase was not impermissibly retroactive because it neither attached new consequences to completed events nor affected vested rights. He held that the "mere upsetting of their expectations as to amounts owed based on future distributions does not make for a retroactive application."

Judge Costa said that a debtor with a confirmed plan is no different from a homeowner who faces increased real estate taxes after purchasing a home.

Next, Judge Costa addressed what he called the "main event": Did the increase contravene the uniformity aspects of the Bankruptcy Clause because it was not applicable in districts with bankruptcy administrators?

Judge Costa found "no uniformity problem" because the Supreme Court found a uniformity violation just once, when a bankruptcy law was made applicable to only one railroad. He said the Supreme Court does not "bar every law that allows for a different outcome depending on where a bankruptcy is filed," such as exemptions that are not uniform among the states.

Finally, Judge Costa rejected the debtor's due process challenge because the "fee increase easily survives rational basis review" and similarly "defeats the takings claim."

The Dissent

Judge Clement was persuaded by *St. Angelo v. Victoria Farms Inc.*, 38 F.3d 1525 (9th Cir. 1994), amended by 46 F.3d 969 (9th Cir. 1995), where the Ninth Circuit found a constitutional defect when an earlier iteration of Section 1930 resulted in different fees between U.S. Trustee and bankruptcy administrator districts. The Ninth Circuit remedied the defect by "equalizing fees."

Significantly, Judge Clement interpreted *St. Angelo* as finding a constitutional violation in "the arbitrary use of two dissimilar systems." She characterized the "underlying constitutional infirmity" as a "dis-uniform law on the subject of bankruptcies."

Now that Congress has again treated debtors differently, Judge Clement said that "the problem is once again causing harm."

In terms of remedy, Judge Clement sided with the Ninth Circuit by saying that the court has "no power to force Alabama and North Carolina into the UST program." So, Judge Clement said she would "ameliorate the harm of unconstitutional treatment" by having the debtor pay fees under the old schedule.

Judge Clement ended her dissent by saying that Congress had created the dual systems for "no better reason than political influence." She noted how bankruptcy administrators were authorized by a "permanent exemption from the UST Program [tucked] into an unrelated bill during the November 2000 lame duck session" of Congress.

In language that could be quoted in future litigation, Judge Clement said she "would hold that the permanent division of the country into UST districts and BA districts violates the Bankruptcy Clause."

While dissenting from the majority's analysis of uniformity, Judge Clement concurred with the majority regarding retroactivity and takings.

Scholarly Observations

The majority opinion cited the leading scholarly commentary on the Uniformity Clause, written by Prof. Stephen J. Lubben, the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at the Seton Hall University School of Law. Stephen J. Lubben, *A New Understanding of the Bankruptcy Clause*, 64 CASE W. RES. L. REV. 319 (2013).

In a message to ABI, Prof. Lubben observed that "the debtor could have only brought up a potentially viable 'uniformity' argument if it had argued that the U.S. Trustee system itself violated the Bankruptcy Clause. Once you concede the validity of the system, it makes perfect sense for Congress to have a two-speed fee system that addresses the fact that there are not U.S. Trustees across the nation."

Prof. Lubben added that "both opinions offer a kind of roadmap for setting up a real challenge to the U.S. Trustee system."

The opinion is *Hobbs v. Buffets LLC (In re Buffets LLC)*, 19-50765, 2020 BL 427007, 2020 Us App Lexis 34866 (5th Cir. Nov. 3, 2020).

Preferences & Claims

Fifth Circuit says that Oklahoma protected that state's oil and gas producers while Texas didn't.

Texas Legislature Didn't Succeed in Giving Lien Priority to Oil and Gas Producers

The Texas legislature blew it.

In 2009, the Delaware bankruptcy court decided that Oklahoma law did not give oil and gas producers a lien in proceeds that would prime the lien of a bank lender. Oklahoma dutifully amended its law in 2010 to close the loophole and protect the state's oil and gas producers.

Texas had a lien statute with the same defect as Oklahoma's, but Texas did not amend its law. You can guess the result: The Fifth Circuit upheld Bankruptcy Judge Craig A. Gargotta of San Antonio by ruling on direct appeal that oil and gas producers in Texas had an unperfected security interest in proceeds that came behind the out-of-state bank's lien on the debtor's deposit accounts.

In her opinion on February 3, Circuit Judge Edith H. Jones said that producers in Texas "must beware 'the amazing disappearing security interest' and continue to file financing statements." She added, "The Texas legislature should take note."

Simple Facts

The facts were simple. Producers in Texas and Oklahoma sold and delivered oil and natural gas to the debtor, a Delaware corporation. The debtor should have paid the producers on the 20th of the month after delivery, but the debtor's chapter 11 filing intervened.

The debtor had sold the producer's petroleum products before filing to so-called downstream purchasers. On the petition date, the debtor had $27.6 million in accounts receivable from the downstream purchasers that were later collected.

The debtor's New York bank had a perfected security interest in deposit accounts, accounts receivable and proceeds. The security agreements with the bank were governed by Delaware law.

The Texas Lien Statute

Judge Jones explained how Texas and Oklahoma exacted "special laws . . . whose purpose was to facilitate and ensure payment to the states' oil and gas producers for sales of their production." The Texas lien law was made a nonstandard provision in the Texas Uniform Commercial Code §

9.343. It gives producers a first priority purchase money security interest in oil and gas produced in Texas. The security interest in the oil and gas and accounts receivable extends for an unlimited time to proceeds and is perfected automatically, without filing a financing statement.

In other words, the Texas nonuniform provision "deviates" from "Texas's (and Delaware's) uniform Article 9 requirements for perfection, the effect of perfection, the length of perfection, and priority among security interests," Judge Jones said.

The Oklahoma Lien Statute

As amended in 2010, the Oklahoma Lien Act § 549 gives producers a lien in proceeds until the producer is paid, without filing a financing statement.

"Critically, 'the interest owner's oil and gas lien created by the Lien Act is not a UCC Article 9 security interest but rather arises as part of a real estate interest of the interest owner in the materials,'" Judge Jones said, quoting Section 549.3.

Texas Producers Lose in Bankruptcy Court

Bankruptcy Judge Gargotta wrote a 49-page opinion in March 2019, ruling that the bank had lien priority over the Texas producers. However, the Oklahoma producers came out ahead of the bank.

The Texas producers appealed. The Fifth Circuit accepted a direct appeal recommended by Judge Gargotta.

The Choice of Law

The producers faced "a formidable choice of law hurdle in that Delaware, the state of Debtor's formal organization, does not recognize certain nonstandard UCC security interests," Judge Jones said. Finding that Delaware's law governed perfection would be a death sentence for the Texas producers because the standard provisions in the Delaware UCC require a financing statement.

Therefore, the pivotal issue was choice of law.

There being no choice of law in the Bankruptcy Code, Judge Jones said that the federal independent judgment test and Texas law both follow the Restatement (Second) of Conflicts. Invoking the Restatement, the Fifth Circuit had previously applied the law of the state with the "most significant relationship."

Also under circuit precedent, the Fifth Circuit had applied the Texas choice of law rules in Texas UCC § 9.301. For priority and perfection, that section looks to the law where the debtor is

"located." In turn, Section 9.307(e) defines "location" as the state of "organization" for a limited liability corporation like the debtor.

Thus, "Delaware law governs the competing priorities under either Texas choice of law or the federal independent judgment test," Judge Jones said. She therefore agreed with Judge Gargotta "that substantive Delaware UCC law governs these priority disputes."

Texans Lose, Sooners Win

The Delaware UCC, of course, requires filing financing statements to perfect security interests in goods, inventory, and proceeds. Consequently, the "Texas Producers are out of luck under Delaware UCC law, which does not recognize the priority of their unfiled, unperfected security interests in proceeds under Texas UCC Section 9.343," Judge Jones said.

Judge Jones affirmed "the bankruptcy court's conclusion that the Bank's interests in the disputed collateral prime any interests held by the Texas Producers."

The Oklahoma producers came out on top because "the Delaware UCC does not preempt statutory liens created by other states," Judge Jones said. She added that "the Oklahoma Lien Act [adopted in 2010] was meant to cure the defects found in the state's Lien Act of 1988 by the Delaware bankruptcy court in *In re SemCrude*. 407 B.R. 112 (Bankr. D. Del. 2009). . . . In that case, the court held that Oklahoma producers were subject, as Texas Producers still are, to UCC rules governing choice-of-law and priority and perfection of security interests."

With regard to the Oklahoma producers, Judge Jones ruled that the producers' liens were prior to the bank's. She remanded for the producers "to prove up the extent and amount of their secured claims."

Observations

Will the Texas producers file motion for rehearing and ask the circuit court to certify the question to the Texas Supreme Court? Or, should it be a certification to the Delaware Supreme Court?

All is not lost for producers in Texas whose purchasers are not (yet) in bankruptcy. They can solve their perfection problems by filing financing statements. But will filings now give them priority over previously perfected bank liens? Texas producers may come out on top because the nonuniform Texas UCC purports to give them purchase money security interests.

The opinion is *Deutsche Bank Trust Co Americas v. U.S. Energy Development Corp. (In re First River Energy LLC)*, 986 F.3d 914 (5th Cir. Feb. 3, 2021).

Tenth Circuit and its BAP follow the same controlling authority but reach opposite results.

Tenth Circuit Panel Splits on a Triangular Preference

Given the same simple facts and the same controlling precedent, a majority on a Tenth Circuit panel disagreed with the circuit's Bankruptcy Appellate Panel about a recurring preference question: Does the recipient of an earmarked loan receive a preference?

Reversing the BAP, the Tenth Circuit saw no preference in a 2/1 opinion, even though a broad reading of the circuit's own authority suggested there was a preference.

One thing is clear, the Tenth Circuit is unlikely to adopt the earmarking defense to a preference, except when a triangular transaction involves codebtors or guarantors.

The Loan from Mother

In bankruptcy court, the facts were undisputed on cross motions for summary judgment.

A son (who later became the debtor) owed $21,700 to a law firm. The son gave his mother a note for $21,700. Three days later, the mother wrote a $21,700 check to the firm drawn on her personal bank account.

The son filed a chapter 13 petition two weeks later. After the case converted to chapter 7, the trustee sued the law firm for a preference.

The mother submitted an affidavit in opposition to the trustee's motion for summary judgment. She said that her son had no interest in the account she used to pay the law firm. She went on to say that the loan was conditioned on paying the law firm and no one else. She said that her son never had any possession, dominion or control over the proceeds, nor could he direct how the proceeds would be applied.

The bankruptcy court denied the law firm's summary judgment motion and granted judgment in favor of the trustee, finding a preference under Section 547. The BAP affirmed. *Stevens Littman Biddison Tharp & Weinberg LLC v. Walters (In re Wagenknecht)*, 18-093, 2019 BL 204831, 2019 Bankr. Lexis 1739 (B.A.P. 10th Cir. June 4, 2019). To read ABI's report on the BAP decision, click here.

The BAP (Incorrectly) Interprets *Marshall*

Although unsuccessfully, the BAP attempted to divine the result from the Tenth Circuit's binding authority, *Parks v. FIA Card Services N.A. (In re Marshall)*, 550 F.3d 1251 (10th Cir. 2008). The BAP found *Marshall* "factually similar."

The debtor in *Marshall* had paid off one credit card balance with a loan from another credit card issued by a different bank. The bank making the loan directly paid off the balance on the other credit card.

Given the expansive definition of "property" in Section 541, the Tenth Circuit in *Marshall* employed two tests to determine whether the loan proceeds were property of the debtor, making the payment a preference. The circuit court in *Marshall* found that both tests were satisfied.

The first test, dominion or control, was satisfied in *Marshall* because the Tenth Circuit said that the transaction was "essentially the same" as if the debtor had drawn down the line of credit on the new card and used the proceeds to pay off the old card balance. *Id.* at 1256.

The second test, diminution of the estate, was satisfied, the Tenth Circuit said, because the loan proceeds "were an asset of the estate for at least an instant before they were preferentially transferred" to pay off the old card. *Id.* at 1258.

Applying *Marshall*, the BAP said that the debtor in the case on appeal exercised "his ability to control the loan proceeds" by signing the note. The BAP found "no material distinction between *Marshall* . . . and this case," because "borrowed funds were used to pay the Debtor's creditor."

On the second test, the law firm argued there was no diminution of the estate, but the BAP said that *Marshall* adopted "a rule of law based upon the purpose served by recovery of preferential transfers." The BAP went on to say that the "dominion/control test and the diminution of the estate test are strained, but they are required by *Marshall*."

The BAP upheld the bankruptcy court's finding of a preference, noting, however, that *Marshall* was "based upon a legal fiction, not reality."

The Circuit Reads *Marshall* Differently

For the court of appeals, the majority opinion on August 24 was authored by Circuit Judge David M. Ebel. Supreme Court Justice Neil M. Gorsuch replaced Judge Ebel on the Tenth Circuit when Judge Ebeltook senior status in 2006.

In the circuit, the appeal turned on whether the transfer was property of the estate. Other elements to a preference were met under Section 547.

Judge Ebel explicated *Marshall* like the BAP but reached the polar opposite result. Unlike the BAP, he said that the case on appeal presented "a different set of facts."

The mother said she would make the loan only to pay the debt to the law firm. Judge Ebel said that the debtor therefore had no dominion and control on the first test because he had no ability to direct the distribution of loan proceeds.

On the second test, Judge Ebel said there was no diminution of the estate because the loan proceeds never became estate property.

The majority reversed the two lower courts and remanded the case, having found no preference.

The Dissent

Circuit Judge Mary Beck Briscoe "respectfully" dissented. She would have found as preference applying *Marshall*. She said that the majority "ignores the realities of the transaction."

In Judge Briscoe's interpretation of the facts, the debtor's assets "effectively increased" by the mother's loan, but his debts increased by the same amount. She saw the son as having dominion and control "constructively" though his mother.

Judge Briscoe also disagreed with the majority's finding that the loan proceeds never became part of the bankruptcy estate. Again citing *Marshall*, she said the test was not whether the net value of the estate changed. Rather, the proceeds would have been estate property had they not been transferred before bankruptcy. *Id.* at 1258.

Judge Briscoe saw the majority as "implicitly" adopting the earmarking doctrine, a judge-made, nonstatutory defense to a preference. In her view, earmarking should not be "extended to situations other than those involving codebtors or guarantors."

In a footnote at the end of the majority opinion, Judge Ebel said that earmarking was not a question on appeal because it was not raised by the appellant. He observed that the Tenth Circuit "has not determined whether the earmarking doctrine applies outside of the codebtor context."

However, Judge Briscoe quoted *Marshall* for saying that earmarking undermines the goals of preference law but is not contained in Section 547.

Observations

Between *Marshall* and the case on appeal, there are subtle differences in the facts that might justify different outcomes.

In *Marshall*, the debtor was drawing on an existing line of credit. In the case on appeal, the debtor had no line of credit with his mother. She was creating an entirely new loan transaction, for one purpose and one purpose only. In *Marshall*, the debtor could have drawn the line of credit for any purpose.

Do the slightly different facts justify different outcomes? Was the *Marshall* panel partial to creditors who would benefit from finding a preference? Was Judge Ebel partial to the defendant because creditors were no worse off?

The defendants were different. In *Marshall*, the defendant was a bank where the preference judgment was just an ordinary cost of doing business. For the law firm, paying the preference was more consequential.

If any of our readers can explain the different outcomes, please let us know.

The opinion is *Walters v. Stevens Littman Biddison Tharp & Weinberg LLC (In re Wagenknecht)*, 19-1206, 2020 BL 320776, 2020 Us App Lexis 26790 (10th Cir. Aug. 24, 2020).

Small Biz. Reorg. Act

Bankruptcy Judge David Warren warns small business trustees that they won't be compensated if they are "overzealous" or undertake "unnecessary or duplicative services."

Subchapter V Trustee Barred from Routine Retention of Counsel

A trustee for a small business debtor under subchapter V of chapter 11 may not routinely retain counsel, according to Bankruptcy Judge David M. Warren of Raleigh, N.C.

Developing the notion that subchapter V was intended to make chapter 11 economically feasible for small businesses, Judge Warren warned trustees at the end of his June 11 opinion that "unnecessary or duplicative services may not be compensated."

The corporate debtor filed a chapter 11 petition in early May and designated itself as a small business debtor intending to wind down the business and culminate in a liquidating plan under subchapter V. The new small business provisions of chapter 11 had become effective on February 19 under the Small Business Reorganization Act, or SBRA. Subchapter V provisions are codified principally at 11 U.S.C. §§ 1181 – 1195.

The so-called CARES Act, adopted on March 27 in response to the coronavirus pandemic, raised the debt limit in subchapter V to $7.5 million, although "not less than 50 percent of [the debt must have arisen] from the commercial or business activities of the debtor." *See* Section 101(51D).

The debtor had retained counsel. Mimicking the usual procedure in chapter 7 cases, the trustee filed an application to retain counsel "as a matter of course." Judge Warren said the trustee "did not have any current need for legal representation in the Debtor's case."

To resolve the application, Judge Warren cited the *Ventura* decision, where Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., observed that the SBRA was intended to streamline reorganization for small business debtors. *See In re Ventura*, 18-77193, 2020 BL 134496, 2020 WL 1867898 (Bankr. E.D.N.Y. April 10, 2020). To read ABI's report on *Ventura*, click here.

Judge Warren listed the trustee's duties in Section 1183(b), which include acting as a fiduciary in lieu of a creditor's committee, "facilitating" the reorganization and "monitoring" the debtor's consummation of the plan. He quoted Bankruptcy Judge Paul Bonapfel, who said in his handbook that employment of professionals may "substantially increase administrative expenses."

Judge Bonapfel went on to say that "courts may be reluctant to permit a sub V trustee to retain attorneys or other professionals except in unusual circumstances." Paul W. Bonapfel, *A Guide to the Small Business Reorganization Act of 2019*, 93 Am. Bankr. L.J. 571, 591 (2019).

Judge Warren also referred to the Justice Department's *Handbook for Small Business Chapter 11 Subchapter V Trustees* 3-17-18 (2020), which says that a subchapter V trustee should "carefully consider[] whether employment of the professional is warranted under the specific circumstances of each case."

Judge Warren held that "authorizing a Subchapter V trustee to employ professionals, including oneself as counsel, routinely and without specific justification or purpose is contrary to the intent and purpose of the SBRA." Significantly, he added that "the Trustee does not need legal assistance to fulfill his basic duties to monitor and facilitate the Debtor's reorganization."

Adding teeth to his interpretation of the limited duties of a subchapter V trustee, Judge Warren inserted a footnote cautioning "overzealous and ambitious Subchapter V trustees that unnecessary or duplicative services may not be compensated, and other fees incurred outside of the scope and purpose of the SBRA may not be approved."

In other words, subchapter V trustees should lend their expertise to assist the debtor and facilitate confirmation of a plan. They are not the equivalent of chapter 13 trustees, and certainly are not akin to trustees in chapter 11 or chapter 7.

To this writer, it appears that the statute silently imposes a greater oversight role on the bankruptcy judge, given the absence of a creditors' committee and the lack of a trustee whose virtual duty is to serve as the debtor's unflagging adversary.

The opinion is *In re Penland Heating & Air Conditioning Inc.*, 20-01795 (Bankr. E.D.N.C. June 11, 2020).

More than 600 cases have already been filed under the SBRA since subchapter V of chapter 11 became effective in February.

Increasingly Popular SBRA Permits Restructuring Personal Guarantees of Corporate Debt

Another court has held that personal guarantees of a defunct business's debts will suffice for an individual to qualify as a debtor under the Small Business Reorganization Act, or SBRA, which is codified primarily at 11 U.S.C. §§ 1181 – 1195.

In the case before Bankruptcy Judge Meredith S. Grabill of New Orleans, the husband and wife debtors had been in chapter 11 for nine months. In April, the U.S. Trustee filed a motion to dismiss or convert the case to chapter 7.

The debtors responded a week later by amending their petition to proceed under the SBRA, also known as subchapter V of chapter 11. Ideally, a small business debtor can confirm a plan under the SBRA without a creditors' committee and without a disclosure statement. It is even possible for a debtor to confirm a plan without a vote of creditors. The SBRA became effective on February 19.

The U.S. Trustee objected to proceeding under the SBRA, citing "no real progress" in the chapter 11 case. A creditor also objected, claiming that the debtors did not qualify under the definition of a "small business debtor" in Section 101(51D)(A).

To be eligible for subchapter V, Section 101(51D)(A) provides that the debtor must be "a person engaged in commercial or business activity" who has not more than $7.5 million in secured and unsecured debt, "not less than 50 percent of which arose from the commercial or business activities of the debtor."

Judge Grabill said that more than $1.1 million of the debtors' debts arose from personal guarantees of debts owing by separately incorporated businesses in which they had interests. Their consumer debts were less than $300,000.

The objecting creditor submitted that "a person engaged in commercial or business activity" means someone who is "currently" engaged in business. The subchapter V trustee, however, argued that "engaged" does not mean "currently engaged."

Judge Grabill agreed with *In re Wright*, 20-01035, 2020 WL 2193240 (Bankr. D.S.C. April 27, 2020), where Bankruptcy Judge Helen B. Burris of Spartanburg, S.C., held that restructuring the debt of a defunct business is enough to qualify. To read ABI's report on *Wright*, click here.

Judge Grabill held that the debtors qualified as small business debtors under the SBRA because their debts "stem from [the] operation of both currently operating businesses and non-operating businesses, and those debts do not exceed the SBRA's debt limit."

The U.S. Trustee primarily objected to treatment under the SBRA in view of "practicality and scheduling issues."

Quoting *In re Progressive Solutions Inc.*, 18-14277, 2020 WL 975464 at *5 (Bankr. C.D. Cal. Feb. 21, 2020), Judge Grabill wrote that "'there are no bases in law or rules to prohibit a resetting or rescheduling of these procedural matters.'" Judge Grabill was referring to rescheduling the status conference and the deadline for filing a plan under the SBRA.

However, Bankruptcy Judge Scott C. Clarkson of Santa Ana, Calif., added *dicta* in *Progressive* by saying there could be a violation of due process rights if a creditor had "vested rights" lost by redesignation under subchapter V. To read ABI's report on *Progressive*, click here.

Judge Grabill said she had allowed creditors to come forward laying out vested rights that would be lost. None did, so she denied the motion to dismiss or convert.

N.B.: Judge Grabill was editor-in-chief of the *Tulane Law Review* and clerked on the Fifth Circuit.

Statistics

Subchapter V is already popular. ABI's Edward Flynn reports that 603 cases have proceeded under subchapter V since the SBRA became effective in February. They are being filed at a rate of about 30 or more cases per week, he said.

The opinion is *In re Blanchard*, 19-12440 (Bankr. E.D. La. July 16, 2020).

To measure eligibility for subchapter V, the debtor must not be an affiliate of a public company that has 20% or more of the 'voting securities.'

An 'Affiliate' of a Public Company Is Barred from Reorganizing Under Subchapter V

An "affiliate" of a public company is barred from reorganizing under the Small Business Reorganization Act, or SBRA, even if the public company controls less than 20% of the stock entitled to vote on filing a bankruptcy petition, according to Bankruptcy Judge Sage M. Sigler of Atlanta.

The SBRA became effective in February and is codified primarily in subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195. Subchapter V is designed for chapter 11 reorganizations to be more streamlined and less costly for small businesses.

A corporation filed a chapter 11 petition and elected treatment under subchapter V, claiming it had less than the maximum of $7.5 million in secured and unsecured debt. The primary lender objected to the debtor's right to proceed under subchapter V, arguing that the debtor is an affiliate of a public company under the Securities and Exchange Act.

The public company owned about 27% of the debtor's voting securities. However, the public company had only 6.5% of the shares entitled to vote on a bankruptcy filing. The debtor argued that it was not an "affiliate" because the public company had less than 20% of the stock that could vote on filing bankruptcy.

The outcome was governed by Section 101(51D)(A), which provides that the debtor in subchapter V must be "a person engaged in commercial or business activity" who has not more than $7.5 million in secured and unsecured debt, "not less than 50 percent of which arose from the commercial or business activities of the debtor."

Subsection 51D(B)(iii) precludes the use of subchapter V by a debtor that is an "affiliate" of a reporting company. In turn, Section 101(2) defines an "affiliate" as an "entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor."

In her October 19 opinion, Judge Sigler held that the public company "owns more than 20% of Debtor's voting securities, and the Court's inquiry ends there."

To reach her conclusion, Judge Sigler confirmed that the public company was an "issuer" under the Securities and Exchange Act of 1934, a requirement under Section 101(51D)(B)(iii)(I). Next, she determined that the 27% owned by the public company consisted of "voting securities."

The debtor contended that the relevant percentage was not 27% but rather 6.5%, the percentage of the stock held by the public company that could vote for bankruptcy. To that, Judge Sigler said it "is irrelevant what percentage of the voting securities held by [the public company] were authorized to vote on Debtor's bankruptcy filing or Subchapter V election."

The debtor wanted Judge Sigler to limit the calculation of "voting securities" to shareholders with the power to vote on the matter before the court. "But," she said, "this limitation does not exist within the language of § 101(2)(A)." In that respect, she disagreed with courts that "characterized the relevant inquiry as whether the alleged affiliate had the opportunity to exert control over the debtor through its voting securities."

The opinion is *In re Serendipity Labs Inc.*, 620 B.R. 679 (Bankr. N.D. Ga. Oct. 19, 2020).

Bankruptcy Judge Scott Clarkson of Santa Ana, Calif., issued the first reported decision on the new small business reorganization law that became effective on February 19.

First Opinion on the SBRA Permits Conversion of an Existing Chapter 11 Case

Bankruptcy Judge Scott C. Clarkson of Santa Ana, Calif., has the distinction of filing the first reported opinion on the new small business reorganization provisions of chapter 11 that became effective on February 19. As you might guess, the opinion deals with whether a debtor may convert an existing chapter 11 case to a small business reorganization under Subchapter V of chapter 11, which vastly simplifies the process of confirming a plan.

Judge Clarkson found no impediment to converting an existing chapter 11 case to Subchapter V, so long as conversion would not jeopardize anyone's "vested rights."

Robert J. Keach of Portland, Maine, told ABI that "the opinion is correct." Keach was the co-chair of the ABI commission that recommended the legislation that Congress adopted in the form of the Small Business Reorganization Act of 2019, or SBRA.

The SBRA

The SBRA shot through Congress like a hot knife through butter. On July 23 and August 1, 2019, the bill passed the House of Representatives and Senate on voice votes, respectively, without debate and without amendments. The President signed the bill on August 23. It was effective on February 19. The SBRA is codified at 11 U.S.C. §§ 1181 – 1195.

In an ideal case under the SBRA, a small business debtor can zip through chapter 11 without a creditors' committee and without a disclosure statement. It is even possible for a debtor to confirm a plan without a vote of creditors. A debtor with aggregate, noncontingent, liquidated secured and unsecured debt less than $2,725,625 is eligible for the SBRA. *See* Section 101(51D).

The corporate debtor in Judge Clarkson's case had been in chapter 11 since November 2018, with an amended plan on file since July 2019. Anticipating the effective date of the SBRA, the debtor filed an amended plan under the SBRA on Jan. 30, 2019, using Official Form 425A. At the same time, the debtor filed a motion for authority to amend the chapter 11 petition to elect treatment under the SBRA.

Converting Is Ok; No Motion Is Required

The debtor's motions were heard by Judge Clarkson on February 20. He filed his opinion and order on February 21, allowing the debtor to proceed under the SBRA.

The debtor's conversion motion was largely without opposition. Most comments from the U.S. Trustee dealt with practical problems and timing issues in converting to an SBRA.

After discussion in court, it was "conceded by all parties," Judge Clarkson said, that the statute has no "stated limitations to the application of the SBRA . . . to pending cases." The U.S. Trustee said there was no prohibition to conversion of a chapter 7 case to an SBRA, according to Judge Clarkson.

Judge Clarkson found no law or rule prohibiting the "resetting or rescheduling" of procedural steps in an SBRA case, such as the initial debtor interview, the Section 341(a) meeting, or the Subchapter V status conference.

If the debtor or "any other party in interest" had "any vested rights" that "would be in jeopardy," Judge Clarkson said in *dicta* that "rescheduling would likely be a violation of due process." Also in *dicta*, he said that someone with "vested rights" could waive an objection to the "re-setting or rescheduling of such events."

Judge Clarkson observed that the "primary purpose of the SBRA is to promote successful reorganizations using the tools that are now available under current law." He therefore "found no legal reason to restrict a pending Chapter 11 case to re-designate to a Subchapter V case, on the facts underlying the Motion." The arguments against conversion "all have to do with practicality and not legality," he said.

Citing Bankruptcy Rule 1009(a), Judge Clarkson nonetheless denied the debtor's motion to authorize conversion to Subchapter V, saying the motion was unnecessary. The rule permits a debtor to amend the petition "as a matter of course at any time before the case is closed."

Judge Clarkson said that "requiring a debtor to seek leave to amend a petition or schedule is improper, especially in light of Rule 1009." He therefore ruled that a motion for conversion to Subchapter V "is unnecessary and not required by law."

Instead, Judge Clarkson said that the debtor should amend the petition to seek relief under Subchapter V, thus invoking "clear procedures for parties" to object. If there is an objection, he said, the "Court may undertake eligibility considerations."

Once the debtor amends the petition, Judge Clarkson said the court would then "set deadlines appropriate to the implementation of the SBRA." In that regard, Keach said that "courts should be liberal in extending the plan filing deadlines" in cases that convert to Subchapter V.

The opinion is *In re Progressive Solutions Inc.*, 18-14277, 2020 BL 63794, 2020 Bankr Lexis 467, 2020 WL 975464 (Bankr. C.D. Cal. Feb. 21, 2020).

A New York court allows a chapter 11 case pending for 15 months to redesignate for treatment under the Small Business Reorganization Act.

Stripping Down a Mortgage on a Mixed-Use Property Under the SBRA

Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., wrote the most thorough survey so far regarding a debtor's ability to use the new Small Business Reorganization Act to propose a plan that would not be possible in an "ordinary" chapter 11.

In his April 10 opinion, Judge Grossman allowed the debtor to elect treatment under the SBRA 15 months after filing a chapter 11 reorganization that was on the verge of failure. He also laid down standards for deciding when a debtor can modify the mortgage on a property used for both residential and business purposes.

The President signed the SBRA into law on August 23. It became effective on February 19. The SBRA is codified as subchapter V in chapter 11, 11 U.S.C. §§ 1181 – 1195.

The Traditional Chapter 11 Was Failing

The debtor had purchased an historic mansion and converted the property to bed and breakfast lodging. As the local law required, she lived in the facility as her principal residence.

As a result of a previous bankruptcy, the debtor no longer had personal liability on the mortgage, which had an outstanding balance of about $1.7 million in principal and interest. The property was worth somewhere in the neighborhood of $1 million, according to the debtor.

On and off, the mortgage had been in default for years. On the verge of foreclosure, the debtor filed a chapter 11 petition in October 2018, but she did not designate herself at the time as a small business debtor.

The debtor had filed a plan proposing to reduce the mortgage to about $1 million, but Judge Grossman had ruled that her plan was nonconfirmable under Section 1123(b)(5), which precludes impairing the mortgage on property that is the debtor's principal residence.

Meanwhile, the debtor's exclusive right to file a plan had terminated. The mortgagee filed a plan calling for the sale of the property and had obtained the votes from unsecured creditors

necessary for confirmation. The mortgagee's plan was set for confirmation on February 26, 2020, seven days after the SBRA became effective on February 19.

Judge Grossman adjourned the confirmation hearing, allowing the debtor an opportunity to amend the petition to designate herself as a small business debtor under the newly effective subchapter V of chapter 11.

Naturally, the debtor amended her petition, but the mortgagee and the U.S. Trustee both objected to treatment under the SBRA.

Eligibility for the SBRA

To be eligible for treatment as a small business debtor under the SBRA as it was originally written, the debtor must have had aggregate, noncontingent, liquidated secured and unsecured debt of less than $2,725,625. *See* Section 101(51D).

In response to the coronavirus emergency, the President signed the $2 trillion Coronavirus Aid, Relief and Economic Security Act. Known as the CARES Act, the law became effective on March 27. Among other things pertaining to bankruptcy, the CARES Act raised the SBRA debt cap for one year to $7.5 million.

The debtor had less than $100,000 in debt other than the mortgage, so she fell well below the monetary cap for a small business debtor.

The U.S. Trustee argued that "procedural issues" nevertheless precluded use of the SBRA. Among other things, the SBRA requires holding a status conference within 60 days of the order for relief and filing a plan within 90 days of the order for relief. Since the order for relief was 15 months before redesignation as a small business reorganization, the U.S. Trustee believed that the debtor did not comply with the deadlines.

Judge Grossman noted that both deadlines may be extended under "circumstances for which the debtor should not be held accountable." *See* Sections 1188(b) and 1189(b). Judge Grossman dispensed with the U.S. Trustee's argument, saying that requiring compliance "with the procedural requirements of a law that did not exist is the height of absurdity."

The Lender's Arguments

Lodging more substantive arguments, the mortgagee contended that allowing the debtor to proceed under the SBRA would prejudice its "vested rights," such as the ability to confirm a plan. Moreover, Judge Grossman had already approved the mortgagee's disclosure statement, and the lender had votes in hand sufficient for confirmation.

Under the SBRA, only the debtor may propose a plan. *See* Section 1189(a). Consequently, the mortgagee would lose the ability to propose or confirm a plan if the debtor could proceed under the SBRA.

Dealing with the applicability of the SBRA to pending cases, Judge Grossman followed *In re Moore Properties of Person County LLC*, 20-80081, 2020 WL 995544 (Bankr. M.D.N.C. Feb. 28, 2020). In *Moore*, Bankruptcy Judge Benjamin A. Kahn of Greensboro, N.C., ruled that the redesignation of a typical small business case under the SBRA does not impair a creditor's constitutional or property rights. *Id.,* 2020 WL 995544, at *4. To read ABI's report on *Moore*, click here.

Section 1190(3): The 'Magic' in the SBRA

For Judge Grossman, the "difficult question" revolved around the debtor's avowed intention to use Section 1190(3). Notwithstanding Section 1123(b)(5), which had barred confirmation of the debtor's ordinary chapter 11 plan, Section 1190(3) allows a small business debtor to modify a mortgage on the debtor's principal residence if the loan was "(A) not used primarily to acquire the real property; and (B) used primarily in connection with the small business of the debtor."

Under the mortgagee's chapter 11 plan, the lender would have been entitled to sell the property. Since the lender's personal claim against the debtor had been discharged previously, the lender only had the ability to realize the value of the property if it were able to confirm its plan.

Therefore, Judge Grossman said, Section 1190(3) "will not deprive [the lender] of any rights [the lender] retained under state law." In addition, the lender still had "all rights granted to a secured creditor under the Code that have not been amended by the SBRA."

In *dicta*, Judge Grossman went on to say he was "not convinced that 11 U.S.C. § 1190(3) would raise sufficient Constitutional doubts to warrant only prospective application."

Next, Judge Grossman dealt with the question of whether applying the SBRA would deprive the mortgagee of "vested rights," since the lender was on the cusp of confirming a plan.

Because the SBRA was not originally available to the debtor, Judge Grossman said he would "not penalize the Debtor because after careful analysis by Congress the law has been amended to address the needs of debtors that engage in the type of business she operates." He noted that the lender retained "many" of the rights it originally had.

The delay occasioned by application of the SBRA, Judge Grossman said, "is not sufficiently prejudicial to [the lender], given the current economic conditions."

The '50%' Test

Next, Judge Grossman considered another eligibility requirement in Section 101(51D). At least 50% of the debt must arise "from the commercial or business activities of the debtor." In that regard, Judge Grossman previously had held that residential mortgages are consumer debts, not commercial debts.

In the case at hand, Judge Grossman said that the debtor's residence in the property "does not control." Rather, the mortgage arose from the debtor's commercial activity. He therefore ruled that the debtor fell within the definition of a small business debtor under the SBRA.

Stripping Down the Mortgage

Finally, Judge Grossman dealt with the debtor's ability to strip down the mortgage to the value of the property under Section 1190(3). He said that subsections (A) and (B) do not bar the debtor from using the section "outright."

Judge Grossman did not rule definitively. Instead, he scheduled a hearing to decide whether the debtor could use Section 1190(3). However, he did offer his interpretation of subsections (A) and (B).

The debtor would not be allowed to cut down the amount of the mortgage under subsection (A), he said, if the debtor used the mortgage proceeds "primarily to purchase the Debtor's residence." Under subsection (B), Judge Grossman said he must decide "whether the primary purpose of the mortgage was to acquire the debtor's residence."

When it comes to applying Section 1190(3), Judge Grossman said that an "inflexible reading of this statute would bar legitimate business owners such as the Debtor from obtaining relief under the SBRA."

To rule on whether the debtor qualified to use Section 1190(3), Judge Grossman said he would hold a hearing to decide (1) whether the mortgage proceeds were used primarily to further the debtor's business; (2) whether the property was an integral part of the business; (3) the degree to which the property was necessary to run the business; (4) whether customers must enter the property to use the business; and (5) whether the debtor uses employees and other businesses to run the operations.

The opinion is *In re Ventura*, 18-77193, 2020 BL 134496, 2020 WL 1867898 (Bankr. E.D.N.Y. April 10, 2020).

The owner of defunct businesses was held ineligible to be a small business debtor because he was no longer the owner of an operating business. Being a non-owner executive of an operating business didn't qualify him.

Split Grows on Whether a Subchapter V Debtor Must Be 'Currently' Engaged in Business

On a question where the lower courts are split, Bankruptcy Judge Edward L. Morris of Fort Worth ruled that the owner of a defunct business does not qualify for reorganization as a small business debtor under subchapter V of chapter 11.

On the petition date, the individual chapter 7 debtor owned seven defunct oil and gas exploration and production companies. All of them were out of business with no plans for returning to operation.

The U.S. Trustee and several creditors objected to the debtor's chapter 7 discharge. In response, the debtor filed a motion for conversion to chapter 11, conditioned on his ability to reorganize as a small business debtor under subchapter V of chapter 11.

Although the debtor was otherwise entitled to convert to chapter 11, the U.S. Trustee and the objecting creditors contended that he was not eligible for subchapter V because the businesses he owned were all defunct.

The debtor countered by pointing to his current employment: He was the president of an oil and gas company owned by his mother. However, he had no ownership interest in his mother's company.

In his March 1 opinion, Judge Morris decided that the debtor was not eligible for subchapter V.

The outcome turned on the definition of a "small business debtor" in Section 101(51D). The term "means a person engaged in commercial or business activities . . . ." Judge Morris gave the terms their "plain and unambiguous meanings" because they are not defined in the Bankruptcy Code.

The debtor argued that "engaged in" encompasses prior ownership and management. Judge Morris disagreed.

The term "is inherently contemporary in focus instead of retrospective, requiring the assessment of the debtor's current state of affairs as of the filing of the bankruptcy petition," Judge Morris said. He said that "engaged in" means "a person occupied with or busy in commercial or business activities – not a person who at some point in the past had such involvement."

Judge Morris found support for his conclusion in cases involving railroad and chapter 12 family farmer reorganizations. He cited the Third Circuit for holding that a former railroad does not qualify for subchapter IV of chapter 11. To qualify for chapter 12, a "majority of courts," he said, require someone to be currently engaged in farming, except when operations are halted seasonally.

Consequently, the debtor was not "engaged in" business and was thus ineligible to be a small business debtor.

Judge Morris also analyzed whether the debtor was engaged in "commercial or business activities." The debtor contended that managing his mother's company qualified.

Again, Judge Morris disagreed. The debtor, he said, was "nothing more than an employee" and was not conducting his mother's business for his own profit.

Judge Morris said that "a person engaged in 'commercial or business activities' is a person engaged in the exchange or buying and selling of economic goods or services for profit." Being an employee of his mother's company, even with "heightened obligations . . . . does not qualify as a small business debtor under section 101(51D)."

Judge Morris therefore denied the motion for conversion to chapter 11 because it was conditioned on qualifying for subchapter V.

Observations

Judge Morris cited Bankruptcy Judge Cynthia A. Norton of Kansas City, Mo., who likewise ruled that debtors must be currently engaged in business to qualify for reorganization under subchapter V of chapter 11. *In re Thurmon*, 20-41400, 2020 WL 7249555 (W.D. Mo. Dec. 8, 2020). To read ABI's report on *Thurmon*, click here.

Judge Morris also cited but disagreed with *In re Wright*, 20-01035, 2020 WL 2193240 (Bankr. D.S.C. April 27, 2020), where Bankruptcy Judge Helen B. Burris of Spartanburg, S.C., held that restructuring the debt of a defunct business is enough to qualify. To read ABI's report on *Wright*, click here.

The opinion is *In re Johnson*, 19-42063, 2021 BL 71942 (Bankr. N.D. Tex. March 1, 2021).

Dealing with the debt left over from a defunct business is enough to qualify as a small business debtor under the new subchapter V of chapter 11, Judge Burris rules.

Currently Conducting Business Isn't Required to Qualify for the SBRA

To qualify as a small business debtor eligible for the streamlined provision of subchapter V of chapter 11, the debtor is not required to be conducting business when filing the original petition, according to Bankruptcy Judge Helen B. Burris of Spartanburg, S.C. Dealing with the debt of a defunct business is enough to qualify.

The April 27 decision by Judge Burris is especially important at a time when many businesses are not generating income. If other courts agree with Judge Burris, small businesses and their owners will be able to proceed under subchapter V, even if they are out of business.

The Defunct Businesses

A man had owned two closely held corporations. Both had been in chapter 11 and sold their assets. Only secured creditors were paid. Neither company had elected treatment as a small business debtor. Both cases were dismissed in 2019, and neither company was conducting business when the owner filed his own chapter 11 petition on February 28.

The owner designated himself for treatment as a small business debtor under subchapter V, which became effective on February 19 pursuant to the Small Business Reorganization Act, codified as subchapter V in chapter 11, 11 U.S.C. §§ 1181 – 1195. He scheduled a total of about $400,000 in debt. From the total, 56% was debt of the two companies that he evidently had guaranteed.

The U.S. Trustee filed a motion to strike the designation as a small business debtor, contending that the owner was not eligible for subchapter V because he was not engaged in business at the time he filed his original petition.

Previously Conducting Business Is Enough

Analyzing the U.S. Trustee's argument, Judge Burris began with the definition of a small business debtor in Section 101(51D). To be eligible for subchapter V, the debtor must be "a person engaged in commercial or business activity" that has not more than $7.5 million in secured and

unsecured debt, "not less than 50 percent of which arose from the commercial or business activities of the debtor."

Judge Burris recognized that the scant legislative history of the SBRA indicates it was "intended to improve the ability of small businesses to reorganize and ultimately remain in business." However, she said, nothing in the definition "limits application to debtors **currently** engaged in business or commercial activities." [Emphasis in original.]

Next, Judge Burris consulted the *Collier* treatise and quoted a section saying that a small business debtor "is not restricted to a person who at the time of filing of the petition is presently engaged in commercial or business activities and who expects to continue in those same activities under a plan of reorganization." 2 *Collier on Bankruptcy* ¶ 101.51D (16th ed. 2020).

To qualify, Judge Burris said that the owner could not rely on the companies' bankruptcies because they had been dismissed. She referred to the definition in Section 101(51D), which includes an affiliate "that *is* also a debtor under this title . . . ." [Emphasis in original.]

Nonetheless, Judge Burris said that coexistent "cases for the person and the affiliate are not required."

Judge Burris held that the owner qualified on his own without reliance on the two companies. She ruled that he was "'engaged in commercial or business activities' by addressing residual business debt and otherwise meets the remaining requirements under § 101(51D)."

The opinion is *In re Wright*, 20-01035, 2020 BL 172550 (Bankr. D.S.C. April 27, 2020).

The SBRA can be used to extinguish a creditors' committee previously appointed in a 'traditional' chapter 11 case.

Three Judges Permit Redesignation under the SBRA, But with Qualifications

With qualifications, three more bankruptcy judges have allowed debtors to redesignate their pending cases as small business reorganizations under the Small Business Reorganization Act, or SBRA.

One court allowed redesignation when a creditors' committee had already been formed in a "traditional" chapter 11 case, and another allowed debtor to convert his chapter 7 case to a case under the SBRA after the chapter 7 trustee had issued a no-asset report. The third evidently would permit refiling under the SBRA, but without shortchanging the chapter 11 creditors' committee in the process.

Effective in February, the SBRA is codified primarily in subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195.

Converting from Chapter 7 to Subchapter V Is Ok

Bankruptcy Judge Michelle M. Harner of Baltimore ruled in a case where the debtor had filed his chapter 7 petition nine days before the SBRA came into effect. The debtor had operated a small business; the case went smoothly; the trustee issued a report of no distribution, and the debtor "appeared" eligible for a discharge, the judge said.

The debtor filed a motion for conversion of his chapter 7 case to subchapter V of chapter 11, along with a motion to reset the deadlines under subchapter V. Section 1188(b) requires a status conference within 60 days of the order for relief, and Section 1189 requires the filing of a plan within 90 days of the order for relief. Because redesignation under subchapter V does not reset the order for relief, both deadlines had passed before the debtor filed the conversion motion.

In her July 7 opinion, Judge Harner cited three decisions permitting redesignation under subchapter V. To read ABI's reports of those cases, click here, here, and here. She noted how both Sections 1188 and 1189 allow extensions of the deadlines under circumstances "for which the debtor should not justly be held accountable."

Examining the facts of the case, Judge Harner said the debtor acted as quickly as he could under subchapter V and had complied with his obligations in chapter 7. She allowed conversion

and set new deadlines because the debtor was not acting in bad faith and the need for extension of the deadlines was "fairly attributable to factors outside of his control."

In *dicta*, Judge Harner said that redesignation might not be allowed if the debtor had not complied with its obligations or missed a deadline to file a plan.

Redesignation Can Extinguish an Existing Committee

Bankruptcy Judge Ernest M. Robles of Los Angeles presided over a case where a couple had filed a traditional chapter 11 petition last year without designating themselves as a small business. An official creditors' committee had been formed and selected counsel, but Judge Robles had not ruled on the committee's retention application when the debtors amended the petition to seek redesignation under subchapter V.

The committee opposed redesignation, but to no avail.

In his June 3 opinion, Judge Robles said the committee would not be "unduly prejudiced" by redesignation, even though the committee might come to an end because there ordinarily are no committees in SBRA cases. He said the committee could demonstrate "cause" for continuation of the committee under Section 1102(a)(3).

To show "cause," Judge Robles said the committee would need to "demonstrate that its continued existence will improve recoveries to creditors, will assist in the prompt resolution of this case, and is necessary to provide effective oversight of the Debtors."

Judge Robles permitted the debtors to proceed in subchapter V, rejecting the idea that "the Debtors' Subchapter V election was motivated primarily by a desire to divest the Committee of its role in this case."

Redesignation Is Ok, but the Committee Must Be Paid

Bankruptcy Judge Frederick E. Clement of Sacramento, Calif., barred a corporate chapter 11 debtor from redesignating under subchapter V if it meant shortchanging counsel for the creditors' committee.

The committee had retained counsel with court approval, but the committee's counsel had not been paid. The debtor wanted Judge Clement to permit dismissal with an immediate refiling under subchapter V.

Based on the notion that estate assets revest in the debtor on dismissal, the debtor intended to pay its counsel after dismissal but not committee counsel.

Judge Clement said "no" in his July 6 opinion.

The committee argued that the strategy was akin to an impermissible structured dismissal precluded by *Czyzewski v. Jevic Holding Corp.*, 137 S. Ct. 973 (2017). To read ABI's report on *Jevic*, click here. Judge Clement agreed, to the extent of observing that the committee would lose its priority claim, even though the debtor's counsel would be paid.

Judge Clement dismissed the case but retained jurisdiction to approve fee applications. He gave the committee's counsel a deadline for filing a fee application and barred the debtor from paying any professionals, including its own, until all fee applications had been resolved and paid in full.

The opinions are *In re Trepetin*, 20-11718 (Bankr. D. Md. July 7, 2020); *In re Bonert*, 19-20836 (Bankr. C.D. Calif. June 3, 2020); and *In re Slidebelts Inc.*, 19-25064 (Bankr. E.D. Calif. July 6, 2020).

Judge Jacobvitz allows the debtor to proceed under the SBRA more than a year after the initial chapter 11 filing.

Another Judge Allows Switching to the SBRA When a Pending Chapter 11 Is About to Fail

Judges in the east and west agree that a debtor can elect treatment under the Small Business Reorganization Act more than a year after commencing a chapter 11 reorganization that is on the verge of failure.

In an opinion on April 30, Chief Bankruptcy Judge Robert H. Jacobvitz of New Mexico aligned with an April 10 decision by Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y. See *In re Ventura*, 18-77193, 2020 BL 134496, 2020 WL 1867898 (Bankr. E.D.N.Y. April 10, 2020). To read ABI's report on *Ventura*, click here.

Judge Jacobvitz's corporate debtor filed a small business petition under chapter 11 in February 2019. The secured lender had a motion to dismiss set for hearing when the SBRA came into effect on February 19, 2020. Dismissal seemed inevitable because the debtor could not confirm a plan, and the 45-day deadline for confirmation had already elapsed under Section 1129(e).

Nine days after the SBRA came into effect and before the hearing on the motion to dismiss, the debtor amended the chapter 11 petition to elect treatment as a small business debtor under subchapter V, codified principally at 11 U.S.C. §§ 1181 – 1195.

Only the U.S. Trustee objected to the debtor's right to treatment under subchapter V, contending that the deadlines under the SBRA for a status conference and plan had already lapsed under Sections 1188 and 1189.

Like Judge Grossman, Judge Jacobvitz rejected the argument. Those sections allow for extensions of deadlines under circumstances "for which the debtor should not justly be held accountable." He said the debtor cannot be held accountable for deadlines that lapsed before the SBRA became effective on February 19.

The U.S. Trustee also argued that the court should not exercise discretion to extend the deadlines because the "old" chapter 11 case was on the verge of failure. To that, Judge Jacobvitz said that the SBRA was "geared to increase the possibility of success for debtors struggling to confirm a plan under chapter 11. It does not make sense to bar Debtor's Amended Petition to take advantage of those provisions after it has encountered the very difficulties Congress sought to address."

Judge Jacobvitz ruled that the debtor was not even required to file a motion for permission to proceed under the SBRA. He overruled the objection and set deadlines for a status conference and the filing of an amended plan.

The opinion is *In re Twin Pines LLC*, 19-10295 (Bankr. D.N.M. April 30, 2020).

With deadlines already elapsed, Judge Grossman disagrees with three judges who allowed redesignation under subchapter V of chapter 11.

Florida Judge Bars Redesignation Under the SBRA When Deadlines Have Already Lapsed

Disagreeing with three decisions by judges in other states, Bankruptcy Judge Scott M. Grossman of Fort Lauderdale, Fla., refused to allow a debtor in a chapter 11 reorganization to redesignate the case for treatment under the newly enacted subchapter V after the deadlines in subchapter V had already lapsed.

The Small Business Reorganization Act, or SBRA, was enacted one year ago and became effective on February 19. The SBRA is codified primarily in subchapter V of chapter 11, 11 U.S.C. §§ 1181 – 1195. It is designed for chapter 11 reorganizations to be more streamlined and less costly for small businesses.

The so-called CARES Act, adopted on March 27 in response to the coronavirus pandemic, made subchapter V even more widely available. It raised the debt limit in subchapter V to $7.5 million, although "not less than 50 percent of [the debt must have arisen] from the commercial or business activities of the debtor." *See* Section 101(51D).

The SBRA has no mandatory creditors' committee or disclosure statement. Only the debtor has the right to file a plan, and there is no absolute priority rule. Plans can sometimes be confirmed without a vote of creditors.

In return for streamlining, subchapter V has short deadlines. Section 1188(a) requires a status conference within 60 days of the order for relief, and Section 1189(b) requires the filing of a plan within 90 days of the order for relief. Both sections allow extensions of the deadlines under circumstances "for which the debtor should not justly be held accountable."

The debtor in Judge Grossman's case had filed a chapter 11 petition in June 2019, designating itself as a small business debtor under the statute as it then read. The inability to assume a franchise agreement and a lease had prevented the debtor from confirming a plan.

On June 19, four months after the SBRA became effective, the debtor amended the petition to elect treatment under subchapter V. The debtor's ability to confirm a plan under the SBRA was questionable because Judge Grossman had ruled that the debtor must pay the landlord $130,000 in

post-petition rent on the effective date. Furthermore, the debtor's business was one that had been effectively shut down by the pandemic.

Although redesignation under subchapter V does not require court approval, Judge Grossman entered an order requiring the debtor to show cause why the case should not be dismissed, because the deadlines under the SBRA had already passed.

The debtor and the subchapter V trustee both opposed dismissal, but Judge Grossman dismissed the case in his August 7 opinion, based on the "plain text" of the statute.

Judge Grossman disagreed with three cases allowing debtors to pursue subchapter V reorganization even though the deadlines had already passed. *See In re Trepetin*, 20-11718, 2020 WL 3833015 (Bankr. D. Md. July 7, 2020); *In re Ventura*, 18-77193, 2020 BL 134496, 2020 WL 1867898 (Bankr. E.D.N.Y. April 10, 2020); and *In re Twin Pines LLC*, 19-10295, 2020 Bankr. Lexis 1217 (Bankr. D.N.M. April 30, 2020). To read ABI's reports on those cases, click here, here, and here.

Judge Grossman focused on the language in Sections 1188(b) and 1189(b), which provide that the status conference and plan-filing deadlines may be extended under circumstances "for which the debtor should not justly be held accountable." He said that the debtor "immediately put itself in default" of the deadlines by making the election for SBRA treatment after the deadlines had passed.

The "justly accountable" standard is higher than the "for cause" standard in Rule 9006(b), Judge Grossman said. He cited the *Collier* treatise for saying that similar language in chapter 12 imposes a "stringent burden."

When a debtor elects treatment under subchapter V after the deadlines have lapsed, Judge Grossman held that "the debtor should justly be held accountable for those circumstances, because the debtor created them. It was the debtor that made the decision to elect into Subchapter V after expiration of these deadlines. No circumstances beyond the debtor's control caused the debtor to make that decision."

Judge Grossman said that a debtor cannot attempt to reorganize in a traditional chapter 11 case, then give it "another try under Subchapter V after expiration of the statutory deadlines."

Judge Grossman dismissed the chapter 11 case because the debtor was accountable for missing the subchapter V deadlines by filing the redesignation after the deadlines had passed.

Had the debtor redesignated under the SBRA soon after February 19, Judge Grossman said that the later advent of the pandemic could have justified an enlargement of the deadlines.

The opinion is *In re Seven Stars on the Hudson Corp.*, 19-17544 (Bankr. S.D. Fla. Aug. 7, 2020).

In a rapid-fire appeal, the Fifth Circuit ruled that the Small Business Act bars bankruptcy courts from enjoining the SBA.

Fifth Circuit Bars Debtors from Receiving 'PPP' Loans Under the Cares Act

In record time, the Fifth Circuit granted a direct appeal and reversed the bankruptcy court on June 22, ruling that the Small Business Act bars the bankruptcy court from entering an injunction that requires the Small Business Administration to grant a so-called PPP loan to a company in bankruptcy.

On April 25, a bankruptcy court in Houston preliminarily enjoined the SBA from barring the chapter 11 debtor from receiving a loan under the Paycheck Protection Program, or PPP. Enacted on March 27 as part of the Coronavirus Aid, Relief and Economic Security Act, the PPP program allows the SBA to make loans that will be forgiven if at least 60% is spent for payroll.

To read ABI's report on the bankruptcy court opinion, click here.

The SBA appealed. The district court stayed the preliminary injunction pending appeal and certified the case for direct appeal. The Fifth Circuit accepted the appeal and accelerated briefing. The last brief in the circuit was filed on June 19. The appeals court issued its three-page opinion three days later.

As it had done in bankruptcy court, the SBA argued in the circuit that 15 U.S.C. § 158(d) prohibits courts from entering injunctions against the SBA. In that regard, the bankruptcy court had found that the SBA's rules prohibiting debtors from receiving PPP loans was an impermissible discrimination against companies in bankruptcy under Section 525(a).

With regard to prohibiting injunctions, the bankruptcy judge said he did "not accept that when I have evidence of bankruptcy discrimination that I can do nothing about it."

The Fifth Circuit dealt with the power to enjoin the SBA in less than one page. In his opinion for the appeals court, Circuit Judge Jerry E. Smith cited Fifth Circuit authority, which "absolutely" prohibits injunctions directed at the SBA.

Bound by circuit precedent, Judge Smith vacated the injunction. He said that the "issue at hand is not the validity or wisdom of the PPP regulations . . . , but the ability of a court to enjoin the [SBA]."

The opinion is *Carranza v. Hidalgo County Emergency Service Foundation (In re Hidalgo Emergency Service Foundation)*, 20-40368 (5th Cir. June 22, 2020).

The Eleventh Circuit decided that the SBA acted within its rulemaking power by precluding chapter 11 debtors from receiving PPP loans under the CARES Act.

Eleventh Circuit Bans Chapter 11 Debtors from Receiving 'PPP' Loans

TheEleventh Circuit reversed the bankruptcy court by holding that the Small Business Administration did not violate the CARES Act, nor did it act arbitrarily, in prohibiting chapter 11 debtors from obtaining "loans" under the Paycheck Protection Program, or PPP.

Bankruptcy courts have been split in deciding whether chapter 11 debtors are entitled to receive PPP loans.

'Loans' Under the CARES Act

The $2.2 trillion Coronavirus Aid, Relief and Economic Security Act became law on March 27 and provided for the SBA to make PPP "loans" that would be "fully forgiven" if at least 75% was spent for payroll. The remainder may be used for interest on mortgages, rent and utilities. Section 1102 of the legislation, known as the CARES Act, contains the provisions regarding the PPP loans.

The SBA issued an application form requiring the applicant to state whether it is "presently involved in any bankruptcy." If the answer is "yes," the form goes on to say that "the loan will not be approved." However, the legislation itself said nothing about excluding companies in bankruptcy from the PPP program.

Pursuant to statutory rulemaking authority, the SBA issued revised regulations on April 28, specifically saying that debtors are excluded because they "would present an unacceptably high risk for an unauthorized use of funds or non-repayment of unforgiven loans."

The Statutory Background

In June, a bankruptcy judge in Florida decided that the SBA violated the Administrative Procedures Act by exceeding its authority and was arbitrary and capricious in excluding debtors from the PPP program. He certified a direct appeal to the Eleventh Circuit. To read ABI's report on the bankruptcy court's opinion, click here.

The 44-page opinion for the Eleventh Circuit on December 22 by Circuit Judge Edward E. Carnes was a straightforward application of the *Chevron* deference doctrine in deciding whether the SBA exceeded its statutory rulemaking authority. *Chevron USA Inc. v. Nat. Res. Def. Council Inc.*, 467 U.S. 837 (1984).

Judge Carnes explained that Congress established the PPP loan program part of the SBA's existing authority to make so-called Section 7(a) loans. By statute, Section 7(a) loans must have "sound value." Creditworthiness is part of the lending criteria.

Even before the PPP, Section 7(a) loan applications inquired as to whether the applicant had ever filed bankruptcy. A prior bankruptcy, however, does not automatically preclude an applicant from receiving a Section 7(a) loan.

Judge Carnes noted that the CARES Act did not exempt applicants from the "sound value requirement" for Section 7(a) loans. However, the CARES Act did give rulemaking authority to the SBA on top of the agency's power to make regulations under 15 U.S.C. § 634(b).

Applying *Chevron* to the PPP Loan Program

The first question in a *Chevron* analysis asks whether the agency exceeded its statutory authority. Judge Carnes found no "unambiguous answer to the question of whether bankruptcy debtors are eligible for PPP loans."

"Instead," Judge Carnes said that the "text of the Cares Act shows Congress placing the PPP within § 7(a), leaving intact the sound value requirement, and delegating rulemaking authority to the SBA."

Judge Carnes therefore concluded that "Congress did delegate to the SBA the question of whether bankruptcy debtors are eligible for PPP loans." He then moved to the second question: Were the SBA's regulations reasonable?

Under *Chevron*, the court does not substitute its judgment for the agency's. Rather, "we consider only whether the SBA's interpretation is rational," Judge Carnes said. He found that the regulations were a "reasonable accommodation" of competing interests.

Finally, Judge Carnes decided that the regulations were neither arbitrary nor capricious, because the standard is "exceedingly deferential."

Judge Carnes summarized his ruling as follows:

> The SBA did not exceed its authority in adopting the non-bankruptcy rule for PPP eligibility. That rule does not violate the Cares Act, is based on a reasonable interpretation of the Act, and the SBA did not act arbitrarily and capriciously in adopting the rule.

Judge Carnes vacated the bankruptcy court's injunction directed at the SBA and remanded with instructions.

The opinion is *USF Federal Credit Union v. Gateway Radiology Consultants PA (In re Gateway Radiology Consultants PA)*, 20-13462, 2020 BL 497712 (11th Cir. Dec. 22, 2020.)

Government often wins by arguing that the Small Business Act prohibits injunctions forcing the SBA to consider granting 'PPP' loans without regard to whether the applicant is a chapter 11 debtor.

Government Notches 4 Victories, Debtors Win Once, in Fights over PPP 'Loans'

In decisions reported last week, chapter 11 debtors only batted 200 in attempts to force the government to make "loans" under the Paycheck Protection Program, or PPP. (For those of you who may have forgotten since the coronavirus shut down major league baseball, a batting average of 200 often means the hitter will be demoted to the minor leagues.)

As we previously reported, the week began when the Fifth Circuit handed down a three-page opinion reversing the bankruptcy court and ruling that the Small Business Act bars the bankruptcy court from entering an injunction effectively requiring the Small Business Administration to grant a so-called PPP loan to a company in bankruptcy. For ABI's report on *Carranza v. Hidalgo County Emergency Service Foundation (In re Hidalgo Emergency Service Foundation)*, 20-40368 (5th Cir. June 22, 2020), click here.

The same day, Chief Bankruptcy Judge Colleen A. Brown of Burlington, Vt., went the other way by granting summary judgment and a permanent injunction in favor of the debtor. Her order requires the SBA to consider the debtor's application for a PPP loan without reliance on the fact that the applicant is a chapter 11 debtor.

All five decisions last week turned on the same issues arising under the Coronavirus Aid, Relief and Economic Security Act, which includes the PPP. Although denominated as loans under the statute enacted on March 27, the loans look more like grants because the recipient is not required to repay the loan if at least 60% is used for payroll.

Debtors typically make two arguments: (1) denial of a loan violates Section 525(a), which prohibits the government from discriminating against someone solely because that person is or has been in bankruptcy; and (2) the SBA's regulations excluding debtors from the PPP program violate the Administrative Procedures Act because they were arbitrary and capricious or without foundation under the statute.

The SBA has several arguments. The government often prevails under Section 634(b)(1) of the SBA, which arguably prohibits courts from enjoining the SBA.

In her 36-page opinion, Judge Brown interpreted the Second Circuit as broadly reading Section 525(a). She concluded that a PPP loan is a "grant," similar to the right to inhabit public housing, which the Second Circuit found to be protected by Section 525(a). She also concluded that the SBA has no sovereign immunity.

In an equally prodigious, 37-page opinion on June 24, District Judge Ellen Lipton Hollander of Baltimore ruled in favor of the government, in a lawsuit filed in district court.

Denying a motion for a preliminary injunction, Judge Hollander concluded that the debtor had not established the requisite likelihood of success on the merits. She found that Section 525(a) did not apply. Invoking *Chevron* deference to evaluate the SBA's regulations, she ruled that the agency was neither arbitrary nor capricious nor unreasonable in interpretating the statute.

Judge Hollander was not required to decide whether Section 634(b)(1) of the SBA precluded her from enjoining the SBA.

Also in district court, District Judge William C. Griesbach of Greenbay, Wis., had withdrawn the reference. On June 16, he denied the debtor's motion for a preliminary injunction based on Section 634(b)(1).

In a decision that came as no surprise, Bankruptcy Judge Michael A. Fagone of Bangor, Maine, followed his June 3 opinion in *Penobscot Valley Hospital v. Carranza (In re Penobscot Valley Hospital),* 20-1005 (Bankr. D. Me. June 3, 2020), by issuing proposed findings and conclusions. He recommended granting the government's motion to dismiss.

To read ABI's report on *Penobscot*, click here.

The opinions are *Carranza v. Hidalgo County Emergency Service Foundation (In re Hidalgo Emergency Service Foundation)*, 20-40368 (5th Cir. June 22, 2020); *Springfield Hospital Inc. v. Carranza (In re Springfield Hospital Inc.)*, 20-01003 (Bankr. D. Vt. June 22, 2020); *Tradeways Ltd v. Dept. of the Treasury*, 20-1324 (D. Md. June 24, 2020); *Fox Valley Pro Basketball Inc. v. S.B.A.*, (E.D. Wis. June 16, 2020); and *Breda LLC v. Carranza (In re Breda LLC)*, 20-1008 (Bankr. D. Me. June 22, 2020).

Judge Thuma of Albuquerque threatens the SBA with punitive damages if the debtor is not granted a $900,000 PPP loan.

Two More Judges Rule that Chapter 11 Debtors Are Eligible for PPP Loans

Two more bankruptcy judges have enjoined the Small Business Administration from barring small companies in chapter 11 from receiving "loans" under the Paycheck Protection Program, or PPP.

Procedurally speaking, Bankruptcy Judge David T. Thuma of Albuquerque, N.M., has gone the furthest by entering a final judgment compelling the SBA to act on the "loan" application without regard for the debtor's "status as a chapter 11 debtor in possession." He went on to say that the debtor could file another adversary proceeding against the SBA "for compensatory and, if appropriate, punitive damages" if the SBA's actions in the past or future "are the proximate cause of [the debtor's] losing its requested $900,000 in PPP funds."

Judge Thuma said that the SBA made an "inexplicable and highhanded decision to rewrite the PPP's eligibility requirements in a way that was arbitrary and capricious, beyond its statutory authority, and in violation of 11 U.S.C. §525(a)."

The PPP "Loan" Program

The PPP was part of the $2.2 trillion Coronavirus Aid, Relief and Economic Security Act, signed into law on March 27. The PPP is contained in Section 1102 of the legislation, known as the Cares Act.

Although denominated as loans, the SBA says on its website that a PPP loan will be "fully forgiven" if at least 75% was spent for payroll. The remainder may be used for interest on mortgages, rent and utilities.

While the Cares Act says nothing about excluding companies in bankruptcy from receiving PPP loans, the SBA promulgated an application form requiring the applicant to state whether it is "presently involved in any bankruptcy." If the answer is "yes," the form goes on to say that "the loan will not be approved."

Pursuant to rulemaking authority contained in the statute, the SBA issued its first regulations on April 15, with nothing to say that chapter 11 debtors were ineligible. The SBA issued revised

regulations on April 28, this time saying that debtors are excluded because they "would present an unacceptably high risk for an unauthorized use of funds or non-repayment of unforgiven loans."

The First PPP Decision

The first out of the starting gate was Bankruptcy Judge David R. Jones of Houston. The debtor had filed a verified complaint on April 22. Judge Jones held a hearing on April 24, issued his findings and conclusions from the bench after the close of evidence, and signed a temporary restraining order on April 25.

Among other things, Judge Jones directed the SBA and the bank administering the program to review the loan application "without any consideration of the involvement of [the debtor] . . . in any bankruptcy." To read ABI's report on the TRO by Judge Jones, click here.

Decisions by Judges Fagone and Thuma

A small hospital in Maine filed a motion for a temporary restraining order on April 27. According to Bankruptcy Judge Michael A. Fagone of Bangor, Maine, the "significant" decline in income from the loss of revenue from elective and nonessential visits meant the hospital might be forced to close by early June.

Judge Fagone held a hearing on April 30 and entered a TRO on May 1. Like Judge Jones, he barred the SBA from denying an application because the applicant is a chapter 11 debtor. He went on to require the SBA to hold back funds to make a "loan" if the debtor is later found eligible.

Judge Fagone decided that the government had no claim of sovereign immunity to preclude him from entering a "carefully tailored temporary restraining order." He then focused on Section 525(a), which bars the government from denying "a license, permit, charter, franchise, or other similar grant" solely because someone is or has been bankrupt.

Judge Fagone said the debtor had shown a "likelihood of success on the merits" because the SBA violated Section 525(a) by having precluded participation in the PPP program "solely because" the debtor is in chapter 11. While Section 525(a) does not apply to loans, he said that the "Cares Act is a grant of aid necessitated by a public health crisis."

Judge Fagone's TRO will remain in effect until May 14. He scheduled a status conference for May 5 on the debtor's motion for a preliminary injunction.

Judge Thuma held a hearing on April 30 to consider a motion for a preliminary injunction filed by the Roman Catholic Church of the Archdiocese of Santa Fe. He went further than granting a preliminary injunction: He entered a "final judgment" in favor of the debtor in the adversary proceeding brought by the archdiocese.

Judge Thuma parsed the PPP legislation and found it had "very few eligibility requirements" and that the archdiocese "clearly met" all of them. The debtor, he said, was losing $300,000 a month in revenue compared to normal operations. Still, the SBA made a final determination denying the application, leaving the debtor with no administrative remedies, Judge Thuma said.

Taking a new tack regarding the PPP, Judge Thuma held that the SBA's denial of the loan application was "arbitrary and capricious," in violation of 5 U.S.C. § 706(2)(A).

The PPP program, he said, "is not a loan program at all. It is a grant or support program. The statute's eligibility requirements do not include creditworthiness . . . . Financial distress is presumed." The loans, he said, "are really grants."

Judge Thuma said "it was arbitrary and capricious for [the SBA] to engraft a creditworthiness test where none belonged." He went on to find that the Cares Act "directly addresses" eligibility requirements and ruled that the SBA had no authority "to change eligibility requirements."

Like Judge Fagone, Judge Thuma also found a violation of Section 525(a) because "the PPP is not a loan program. It is a grant or support program." He added teeth to his judgment by declaring that the archdiocese could seek compensatory and, "if appropriate," punitive damages if the SBA's action results in the debtor's not receiving the $900,000 it requested.

The opinions are *Calais Regional Hospital v. Carranza (In re Calais Regional Hospital)*, 20-1006, 2020 BL 169827 (Bankr. D. Maine May 1, 2020); and *Roman Catholic Church of the Archdiocese of Santa Fe v. U.S. (In re Roman Catholic Church of the Archdiocese of Santa Fe)*, 20-1026, 2020 BL 169101 (Bankr. D.N.M. May 1, 2020).

Consumer Bankruptcy

Discharge/Dischargeability

Reading Husky narrowly, the Eleventh Circuit requires that fraud occur before a debt arises to make the debt nondischargeable under Section 523(a)(2)(A).

Eleventh Circuit Reads *Husky* Narrowly, Perhaps Too Narrowly

The Eleventh Circuit wrote a decision on September 29 narrowly reading *Husky International Electronics Inc. v. Ritz*, 136 S. Ct. 1581 (2016), where the Supreme Court held that a debt can be nondischargeable under Section 523(a)(2)(A) if it was obtained by "actual fraud" in the absence of a misrepresentation to the creditor.

Following the statutory language in Section 523(a)(2)(A) but setting aside the implications of *Husky*, the circuit's opinion by District Judge John Antoon, II shows how actions that can lead to a denial of discharge won't necessarily also make a particular debt nondischargeable. Judge Antoon was sitting in the circuit by designation.

Time will tell whether other courts will follow the Eleventh Circuit by adhering more to the language of the statute than to *Husky*.

Bad Facts for the Debtor

The debtor was up to no good, after giving a personal guarantee for $12.5 million in corporate debt. When the company's finances were declining, the debtor began transferring property to his wife and his daughter. He continued transferring assets after the lender sued on his guarantee.

The debtor continued making transfers around the time the lender won a $9.1 million judgment against him.

The lender sued in state court to set aside fraudulent transfers. At that point, the debtor filed bankruptcy, prompting the lender to start an adversary proceeding claiming that the $9.1 million judgment was nondischargeable under Sections 523(a)(2)(A) and (a)(6).

The lender contended that the judgment was nondischargeable under Section 523(a)(2)(A) because the debtor had transferred assets to hinder its collection efforts.

Affirmed in district court, the bankruptcy court granted the debtor's motion to dismiss for failure to state a claim. Regarding Section 523(a)(2)(A), the bankruptcy court reasoned that the

underlying debt was nothing more than "standard contract debt" and had not been obtained by fraud.

On the Section 523(a)(6) claim, the bankruptcy court said that the debt arose from a personal guarantee, not from willful or malicious injury.

The lender appealed to the circuit.

The Elements of a 523(a)(2)(A) Claim

Section 523(a)(2)(A) bars discharge of a debt "obtained by . . . false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition."

Judge Antoon said that the lender could not argue that the debtor "fraudulently obtained money or property" from the lender. The lender only alleged there was fraud in transfers after the debt had been incurred. He said the "money that the bank loaned is obviously not traceable to those later conveyances."

The lender based its arguments on a "strained interpretation of, and *dicta* in," *Husky*, Judge Antoon said.

What Does *Husky* Mean?

Therein lies the question. Was *Husky* distinguishable, or was it on point? Even if it was distinguishable, did *Husky* announce a policy that lower courts should follow? To read ABI's report on *Husky*, click here.

In the 7-1 *Husky* decision, Justice Sonia Sotomayor said that the words "obtained by . . . actual fraud" in Section 523(a)(2)(A) subsume "forms of fraud, like fraudulent conveyance schemes, that can be effected without a false representation." *Id*. at 1586.

In *Husky*, a man caused his company to transfer funds to other companies that he owned or controlled. He later went bankrupt, leaving the creditor with a $164,000 debt owing by the company. The creditor sued the man in bankruptcy court to hold him liable for the corporate debt and to bar discharge of the debt under Section 523(a)(2)(A). The Fifth Circuit upheld discharge of the debt because there was no misrepresentation to the creditor.

Reversing the Fifth Circuit, Justice Sotomayor said that "false representation has never been a required element of 'actual fraud,' and we decline to adopt it today." *Id*. at 1588. She said that nothing in the statutory words "obtained by . . . actual fraud" requires that the fraud occurred at the inception of the credit transaction. *Id*. at 1589.

At its broadest, *Husky* could be read to mean that fraudulent transfers made to hinder collection of a debt can render the debt nondischargeable under Section 523(a)(6)(A), even if the fraudulent transfers occur after the debt was incurred.

Judge Antoon read *Husky* more narrowly.

The Circuit's Narrow Reading of *Husky*

Judge Antoon said the holding of *Husky* was "narrow." In *Husky*, he said, "someone other than the bankruptcy debtor initially owed a debt for which the bankruptcy debtor later became at least partially liable." The debtor became liable under a state veil-piercing statute when he drained the corporation of assets.

In *Husky*, Judge Antoon said that the "fraudulent acts created or potentially created the very debts at issue." That is to say, the liability arose when the fraudulent transfers occurred.

Judge Antoon said that the Supreme Court never "eliminated the requirement" that "the money or property giving rise to the debt must have been 'obtained by' fraud, actual or otherwise." He read *Husky* to mean that the Supreme Court "merely recognized the possibility that fraudulent schemes lacking a misrepresentation . . . can satisfy the 'obtained by' requirement in some circumstances."

Because the liability on the guarantee "existed long before" the debtor began transferring assets, Judge Antoon said it was "an ordinary contract debt that did not arise from fraud of any kind." He therefore upheld dismissal of the claim under Section 523(a)(2)(A).

Charles Tatelbaum told ABI about his concern that "this narrow interpretation of Section 523 will create a roadmap for unscrupulous debtors." Tatelbaum is a partner with Tripp Scott PA in Fort Lauderdale, Fla.

Dismissal Upheld on Section 523(a)(6)

Section 523(a)(6) bars discharge of a debt "for willful and malicious injury by the debtor to another entity or to the property of another entity."

Judge Antoon said the debt must arise "as a result of" the willful and malicious injury. In the case on appeal, he said that the "contract debt . . . was incurred long before the challenged conveyances." He therefore upheld dismissal of the claim under Section 523(a)(6).

Observations

Judge Antoon is correct that the facts in *Husky* are distinguishable. But was it *dicta* when Justice Sotomayor said that nothing in the statutory words "obtained by . . . actual fraud" requires that the fraud occurred at the inception of the credit transaction?

When there are no constitutional questions to decide, the Court does not review individual cases like a court of error. The Court did not write *Husky* to apply only to cases arising under the particular Texas veil-piercing statute. Does *Husky* state a policy to apply more broadly in cases under Section 523(a)(2)(A)?

However, the result in the Eleventh Circuit is significant: Actions that could lead to denial of discharge under Section 727(a)(2) for making a fraudulent transfer "with actual" intent may not also make a particular debt nondischargeable. Indeed, the creditor in the Eleventh Circuit appeal very possibly could have brought an adversary proceeding that would have resulted in the denial of discharge of all debts.

Husky opened the door for one creditor to have its debt excepted from discharge when the debtor should have lost his or her discharge entirely. Laudably, the Eleventh Circuit's opinion will force creditors to pursue the denial of discharge, not just a declaration that a particular debt was excepted from discharge.

The opinion is *SE Property Holdings LLC v. Gaddy (In re Gaddy)*, 19-11699 (11th Cir. Sept. 29, 2020).

The Supreme Court has ducked the split twice in recent years but should tackle the question this time around.

Circuit Split Widens over Discharging Taxes on Late-Filed Returns

Widening an existing split of circuits, the Eleventh Circuit rejected the one-day-late rule adopted by three circuits and held that a tax debt can be discharged even if the return was filed late.

The Atlanta-based circuit aligned itself with the Third, Fourth, Sixth, Seventh, Eighth and Eleventh Circuits, which employ the four-part *Beard* test, named for a 1984 Tax Court decision. *Beard v. Commissioner of IRS*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986). Following *Beard*, it's possible — but not automatic — to discharge the debt on a late-filed tax return.

The First, Fifth and Tenth Circuits hold that a tax debt never can be discharged as a consequence of the hanging paragraph in Section 523(a) if the underlying tax return was filed even one day late.

The Supreme Court has been ducking the split. Columbia University Law Professor Ronald J. Mann attempted to take a one-day-late case to the Supreme Court in 2015. The high court denied *certiorari*. *Mallo v. IRS*, 135 S. Ct. 2889, 192 L. Ed. 2d 924 (2015). In February 2017, the justices denied *certiorari* in *Smith v. IRS*, where the petitioner's counsel raising the same issue was Prof. John A.E. Pottow from the University of Michigan Law School. *Smith v. IRS*, 137 S. Ct. 1066, 197 L. Ed. 2d 176 (2017).

Participating in oral argument in the Eleventh Circuit on behalf of the debtor, Prof. Pottow resurrected the argument and won this time around. If the Massachusetts taxing authority files a petition for *certiorari*, it will be difficult for the Supreme Court to dodge the question once again.

The January 23 opinion for the Eleventh Circuit by Circuit Judge R. Lanier Anderson, III picks apart the logic employed by the three circuits that refuse to discharge tax debts under all circumstances if the return was even a day late. The statutory analysis employed by Judge Anderson and advocated by Prof. Pottow raises questions of statutory interpretation that are the Supreme Court's bread and butter.

In a footnote, Judge Anderson said that Prof. Pottow's "briefing and oral argument were very helpful in untangling this corner of bankruptcy law."

Simple Facts

The case is a good vehicle for Supreme Court review because it entails none of the difficult issues that sometimes arise under the *Beard* test. Indeed, the state taxing authority stipulated that the debtor satisfied all four parts of the *Beard* test. Instead, the state argued that the debt was nondischargeable because the debtor was late in filing his return.

The debtor had filed his 2008 state tax return in late 2009, seven months late. He filed a chapter 7 petition six years later and received a general discharge in January 2016. Then, the state resumed collection activities.

The debtor reopened his bankruptcy case, and the parties filed cross motions for summary judgment on the dischargeability of the tax debt. Bankruptcy Judge Karen S. Jennemann of Orlando, Fla., ruled in favor of the debtor, discharging the debt. She was upheld in district court, prompting the taxing authority to appeal a second time.

The Confusing Statute

Two provisions of the Bankruptcy Code come into play. Section 523(a)(1) bars discharge if no "return" was filed or if the return was filed less than two years before bankruptcy.

Until Congress added the so-called hanging paragraph in Section 523(a) in 2005, the Bankruptcy Code had not defined "return." Added in 2005, the unnumbered subsection in Section 523(a) defines a "return" as a "return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements)." The term includes "a return prepared pursuant to Section 6020(a)" of the IRS Code but excludes "a return made pursuant to Section 6020(b)" of the IRS Code.

Section 6020(a) governs "substitutes for returns," where the IRS drafts a return with the taxpayer's cooperation. Significantly, Judge Anderson quoted the IRS in another case as having said that Section 6020(a) is "almost never used."

Section 6020(b) allows the IRS to file a return without the taxpayer's cooperation. In other words, the hanging paragraph bars discharge if the taxing authority has filed a return without the debtor's cooperation, but permits discharge if the IRS files a return with the debtor's cooperation.

In substance, the question for Judge Anderson was this: Did the debtor satisfy "the applicable filing requirements"?

Judge Anderson's Statutory Analysis

The First, Fifth and Tenth Circuits believe that the plain language of the hanging paragraph means that a late tax return does not qualify for discharge. Judge Anderson conceded that the argument "has some force to it." However, he did not agree that "the phrase 'applicable filing requirements' *unambiguously* includes filing deadlines." [Emphasis in original.]

To the contrary, he said the "best reading" of "applicable filing requirements" must include the statutory context. He said the court must also devise an interpretation that gives meaning to every word in the statute.

Judge Anderson distinguished between "applicable filing requirements" and "other" filing requirements. He decided that "applicable" means "something different from 'all.'"

Examining the "statutory context," Judge Anderson concluded that "applicable" relates to "whether the document at issue can reasonably be deemed a 'return.'"

Significantly, Judge Anderson noted that Section 523(a)(1) predated the adoption of the hanging paragraph and was not altered by Congress in 2005. "By negative implication," he said, a tax debt can be discharged if the return was filed more than two years before bankruptcy.

The one-day-late approach, Judge Anderson said, "would render Section 523(a)(1)(B)(ii) a near nullity." That section "explicitly permits the discharge of at least some late-filed returns," he said.

Judge Anderson rejected the taxing authority's approach to statutory interpretation because it "would render the dischargeability limitation in Section 523(a)(1)(B)(ii) *insignificant*" and would apply only to a "subset of already 'minute' set of tax returns." [Emphasis in original.]

Adopting the analysis of the three circuits, Judge Anderson said, "would run counter" to the Supreme Court's refusal to construe statutes in a manner that would make them "'entirely superfluous in all but the most unusual circumstances,'" quoting *Roberts v. Sea-Land Services Inc.*, 566 U.S. 93 (2012).

Judge Anderson said it was "deeply implausible" that Congress intended for "Section 523(a)(1)(B)(ii) to apply only in such a handful of cases despite no such limitation appearing in that provision itself." He did not believe that Congress would curtail dischargeability "so starkly without a clearer indication that it was indeed intending to do so."

Judge Anderson explained in detail why he was not persuaded by the opinions from the First, Fifth and Tenth Circuits. He upheld the discharge of the debtor's tax liability because he determined that the late return satisfied the requirements for a "return" under both the *Beard* test and Massachusetts tax law.

Will Massachusetts File '*Cert*'?

Massachusetts won in the First Circuit on exactly the same question. Since most Massachusetts residents will file bankruptcy in the First Circuit, the state may see no reason for filing a petition for *certiorari* from its loss in the Eleventh Circuit.

However, a debtor in the First Circuit in the future could raise the issue expecting to lose but intending to file a petition for *certiorari* based on the circuit split. One way or another, the issue should eventually bubble to the surface in the Supreme Court.

The opinion is *Mass. Dept. of Revenue v. Shek (In re Shek)*, 18-14992, 2020 BL 23121 (11th Cir. Jan. 23, 2020).

Tenth Circuit joins the Fifth Circuit by holding that student loans are not 'educational benefits' under Section 523(a)(8)(A)(ii).

Not All Student Loans Are Nondischargeable, Tenth Circuit Holds

In a victory for people burdened with student loans, the Tenth Circuit joined the Fifth Circuit by holding that a loan to finance education is dischargeable unless it was either a "qualified education loan" as defined in the Internal Revenue Code or was made, insured, or guaranteed by a governmental unit or nonprofit institution.

If a loan does not fit into one of those two categories, the debt is dischargeable. In other words, Section 523(a)(8) does not mean that all student loans are nondischargeable.

Technically speaking, the Tenth Circuit held that a student loan is not an "obligation to repay funds received as an educational benefit" under Section 523(a)(8)(A)(ii).

The Student Loans

The husband and wife debtors had more than $200,000 in student loans. About half were to finance tuition and were nondischargeable under Section 523(a)(8)(B) because they were "qualified education loans."

From the total, about $107,000 were so-called tuition answer loans made to pay the debtors' living expenses while attending college. The tuition answer loans were not made or guaranteed by a governmental unit or nonprofit institution, nor were they qualified education loans.

The debtors confirmed a chapter 13 plan and received a discharge years later. The plan put all of the debtor's education loans into a separate class where payment was deferred "until the end of the plan." The plan did not say whether the student loans would or would not be discharged. Likewise, the discharge order only said that "most" student loans are not discharged.

During the life of the plan and continuing for about two years after discharge, the debtors paid about $65,000 on their student loans, including the tuition answer loans.

Two years after discharge, the debtors reopened their case and filed a complaint seeking a declaration that the $107,000 in tuition answer loans was not discharged. They also sought damages for collection actions that allegedly violated the discharge order.

The lender filed a motion for summary judgment, asking Bankruptcy Judge Kimberley H. Tyson of Denver to rule that none of the debtors' student loans were dischargeable, including the tuition answer loans. The lender also wanted Judge Tyson to rule that nondischargeability of the student loans was *res judicata* by virtue of the confirmation order.

Judge Tyson rejected the *res judicata* argument. She also denied the lender's summary judgment motion, ruling that the tuition answer loans were discharged because they were not an "educational benefit" under the plain language of Section 523(a)(8)(A)(ii).

Judge Tyson certified a direct, interlocutory appeal to the court of appeals. The Tenth Circuit accepted the appeal and upheld Judge Tyson in an opinion on August 31 by Circuit Judge Jerome A. Holmes.

Student Loans Are Not an Educational Benefit

In significant part, Judge Holmes followed the Fifth Circuit's opinion in *Navient Solutions LLC v. Crocker (In re Crocker)*, 941 F.3d 206 (5th Cir. Oct. 21, 2019). The New Orleans-based court held that an "obligation to repay funds received as an educational benefit" under Section 523(a)(8)(A)(ii) does not include student loans. To read ABI's report on *Crocker*, click here.

Judge Holmes explained that Section 523(a)(8) makes student loans nondischargeable if they fall into one of three categories: (1) a "qualified education loan," as defined in the IRS Code, under Section 523(a)(8)(B); (2) a "loan made, insured, or guaranteed by a governmental unit, or . . . funded . . . by a governmental unit or nonprofit institution . . . ." under Section 523(a)(8)(A)(i); or (3) "an obligation to repay funds received as an educational benefit, scholarship or stipend" under Section 523(a)(8)(A)(ii).

The lender conceded that the tuition answer loans were neither qualified education loans nor made or guaranteed by a governmental unit or nonprofit organization. As a function of statutory construction, Judge Holmes concluded that the tuition answer loans were discharged because "they are not 'obligations to repay funds received as an educational benefit.'"

Observing that Section 523(a)(8)(A)(ii) does not include the word "loan," Judge Holmes concluded that "Congress presumably did not intend" the subsection "to also cover" loans. If Section 523(a)(8)(A)(ii) made loans nondischargeable, the other provisions in Section 523(a)(8) would be surplusage, he said.

To Judge Holmes, it was "clear" that "the statutory terms 'obligation to repay funds received as an educational benefit' and 'educational loan' mean separate things."

For a "normal English speaker," Judge Holmes said, an "educational benefit" refers "to things like a health benefit, unemployment benefit, or retirement benefit." In other words, he said, a benefit "implies a 'payment,' 'gift,' or 'service' that ordinarily does not need to be repaid."

Judge Holmes based his conclusion on the canon against surplusage and the canon of *noscitur a sociis*. Roughly speaking, the *noscitur* canon means that ambiguous words should be interpreted by considering the words with which they are associated in the text.

Loans must always be repaid, but the words "scholarship" and "stipend" in Section 523(a)(8)(A)(ii) signify something that may not need to be repaid. Judge Holmes therefore relied on the *noscitur* canon in concluding that "educational benefit" does not include loans. In other words, he said that the amendments in 2005 did not make all private student loans dischargeable, as the Fifth Circuit "persuasively" ruled in *Crocker*.

Like Bankruptcy Judge Tyson, Judge Holmes rejected the notion that *res judicata* made the loans nondischargeable.

The only provision in the plan dealing with student loans said they were deferred until the end of the plan. Judge Holmes could therefore "discern nothing in the plan . . . showing that their Tuition Answer Loans are excepted from discharge." Thus, "the issue [regarding discharge of student loans] is not *res judicata* under the plan."

Affirming Bankruptcy Judge Tyson and remanding for further proceedings, Judge Holmes held "that § 523(a)(8)(A)(ii) does not except student loans from discharge and, consequently, that the exception does not cover the [debtors'] Tuition Answer Loans."

The opinion is *Navient Solutions LLC v. McDaniel (In re McDaniel)*, 18-1445, 2020 BL 331051, 2020 Us App Lexis 27687 (10th Cir. Aug. 31, 2020).

Courts are split over the effect on claims discharged in chapter 7 if the debtor converts the case to chapter 13.

Claims Discharged in Chapter 7 Revive If the Case Is Converted to Chapter 13

If a chapter 7 case is converted to chapter 13 after the debtor receives a discharge, creditors with discharged claims are entitled to the allowance of their claims in chapter 13, according to Bankruptcy Judge Laura K. Grandy of East St. Louis, Ill., who took sides on an issue where the courts are split.

Judge Grandy is not announcing the end of so-called chapter 20 cases. In chapter 20, the debtor will have received a discharge in chapter 7 but will file an entirely new chapter 13 petition, not convert the chapter 7 case to chapter 13. In her court, the debtor was attempting a strategy that required conversion to chapter 13, not filing an entirely new petition.

After the debtor received his chapter 7 discharge, the trustee discovered an annuity that might be an asset. Rather than turn over the asset, the debtor converted his case to chapter 13.

The court served a notice of the chapter 13 bar date. A creditor who had not filed a claim in chapter 7 did file a claim for about $1,300 in the chapter 13 case. The debtor objected to allowance of the claim, contending that the debt had been discharged in chapter 7.

Judge Grandy disagreed in her August 7 opinion. She admitted that the Bankruptcy Code "offers little guidance as to what happens if the debtor seeks to convert their case after receiving a Chapter 7 discharge."

Judge Grandy began by quoting Section 524(a)(2) which provides that a discharge "operates as an injunction against . . . any act, to collect . . . any such debt as a personal liability of the debtor." In other words, she said that a "discharge eliminates a debtor's personal liability for a debt, [but] it does not extinguish the liability of the bankruptcy *estate*." [Emphasis in original.]

On the other side of the fence, Judge Grandy said "there is a line of cases which have held or at least assumed that upon conversion after a discharge, any dischargeable debts scheduled in the Chapter 7 case are effectively eliminated and not entitled to distributions under the Chapter 13 plan."

Judge Grandy gave several examples for how the debtor's theory would break down in practical application. For example, no debts would remain for payment in chapter 13. Or, she said,

"An unscrupulous debtor could conceal assets in the Chapter 7 in order to avoid liquidation and then convert to Chapter 13 in order to retain the asset to the detriment of creditors."

Judge Grandy summarized the analysis like this: The bankruptcy estate was formed on the filing of the chapter 7 petition. Claims in existence became claims against the estate. On conversion, the filing date remained the same. So, prepetition claims in chapter 7 became claims in the chapter 13 case. Creditors with valid claims who filed timely claims in the chapter 13 case are entitled to receive distributions "despite the existence of the Chapter 7 discharge."

Observation

Judge Grandy's opinion does not undercut the theory for chapter 20 cases, where debtors can fully extinguish the personal obligation and underwater liens on a home mortgage. In chapter 20, the debtor files a new petition in chapter 13 (to extinguish the underwater lien) after receiving a chapter 7 discharge.

Judge Grandy's opinion explains why a chapter 20 strategy would not work by converting to chapter 13 rather than filing a new petition.

The opinion is *In re Pike*, 17-40736, 2020 BL 301262 (Bankr. S.D. Ill. Aug. 7, 2020).

Fraudulent Transfers/Children's Tuition

Following the answer by the Texas Supreme Court to a certified question, the Fifth Circuit again rules that an inability to discover fraud won't absolve a transferee from the duty to investigate suspicions of fraud.

Fifth Circuit Again Says: No 'Futility Defense' Under the Texas UFTA

For the second time in the same case, the Fifth Circuit has ruled that the good faith defense to a fraudulent transfer under Texas law requires a defendant with "inquiry notice" to conduct a "diligent inquiry," even if investigation would have been fruitless.

This time, the conclusion by the court of appeals was buttressed by an opinion from the Texas Supreme Court resolving a previously undecided question under Texas law. The outcome is remarkable because the same defendant would have had a good defense if the suit were under Section 548.

The Stanford Ponzi Scheme

The appeal arose in the wreckage of the $7 billion Ponzi scheme orchestrated by R. Allen Stanford, now serving a 110-year prison sentence.

Appointed by the Securities and Exchange Commission, the Stanford receiver filed suit under the Texas Uniform Fraudulent Transfer Act, or TUFTA, against an investor who took out $79 million in principal shortly before the fraud was exposed, but after news of the SEC investigation was public knowledge. The district court ruled that the investor was the recipient of a transfer made with actual intent to hinder, delay or defraud. To prove a claim under TUFTA, the receiver was required to show that the defendant was not in good faith, because return of principal provided "reasonably equivalent value."

The jury concluded that the defendant was on inquiry notice regarding good faith. However, the jury decided that an investigation would have been futile. Believing that the defendant passed the good faith defense under Texas law, the district court ruled against the receiver, who appealed.

The First Fifth Circuit Opinion

In January 2019, the Fifth Circuit reversed and found the defendant liable. *Janvey v. GMAG LLC*, 913 F.3d 452 (5th Cir. Jan. 9, 2019). The appeals court made a so-called *Erie* guess by

presuming that the Texas Supreme Court would not recognize the futility defense. The circuit court noted that the same facts would have given the transferee a complete defense were the suit under Section 548(c) of the Bankruptcy Code.

The defendant who received the fraudulent transfer filed a motion for panel rehearing and rehearing *en banc*. In May 2019, the panel granted the motion for panel rehearing, vacated the opinion from January, and certified a question, asking the Texas Supreme Court to decide whether a defendant on inquiry notice who did not conduct an inquiry is nonetheless entitled to the good faith defense if inquiry would have been futile. *Janvey v. GMAG LLC*, 925 F.3d 229 (5th Cir. May 24, 2019).

To read ABI's reports on the first and second Fifth Circuit opinions, click here and here.

The Texas Supreme Court Rules for the Receiver

As it turned out, the guess by the Fifth Circuit was spot on. In an opinion on December 20, the Texas Supreme Court ruled that "a transferee seeking to prove good faith must show that it investigated the suspicious facts diligently. A transferee who simply accepts a transfer despite knowledge of facts leading it to suspect fraud does not take in good faith." *Janvey v. GMAG, L.L.C.*, 592 S.W.3d 125, 131 (Tex. 2019).

If a diligent inquiry would not have disclosed fraud, the state high court went on to hold that "choosing to remain willfully ignorant of any information an investigation might reveal is incompatible with good faith . . . . If the transferee fails to demonstrate its good faith and avoid willful ignorance by conducting a diligent investigation, it cannot be characterized as acting with honesty in fact." *Id*. To read ABI's report, click here.

The Third Opinion by the Fifth Circuit

The answer to the certified question was not completely dispositive, because the Texas Supreme Court did not say how much of a diligent investigation establishes good faith, nor did the state court say whether the defendant in the Fifth Circuit had performed a diligent investigation.

The defendant conceded it was on inquiry notice. The open questions therefore called on Circuit Judge Carl E. Stewart to scour the trial record and determine whether the jury's conclusion about lack of good faith was based on sufficient evidence. In Texas, he said, a defendant on inquiry notice "cannot satisfy the good faith defense without first diligently investigating his or her initial suspicions of fraud."

Reciting the evidence most favorable to the defendants, Judge Stewart concluded that the "record does not show the [defendants] accepted the fraudulent transfers in good faith." For a second time, he therefore reversed the district court and granted judgment in favor of the trustee.

The opinion is *Janvey v. GMAG LLC*, 17-11526, 2020 BL 390290 (5th Cir. Oct. 8, 2020).

Texas Supreme Court rules that an inability to discover fraud won't absolve a transferee from the duty to investigate suspicions of fraud.

The Texas UFTA Has No 'Futility Defense' When a Transferee Is on Inquiry Notice

Answering a certified question from the Fifth Circuit, the Texas Supreme Court held that a defendant in a fraudulent transfer suit who is on inquiry notice, but does not investigate, is not entitled to the good faith defense even if inquiry would have been futile.

In his December 20 opinion for the Texas high court, Justice J. Brett Busby said that holding "otherwise rewards willful ignorance and undermines the purpose of" the Texas Uniform Fraudulent Transfer Act, or TUFTA.

"The ruling will have a significant effect on fraudulent transfer litigation not only in Texas, but in other jurisdictions around the country," Eric D. Madden, a partner with Reid Collins & Tsai LLP of Dallas, told ABI. Madden submitted an *amicus* brief in the Texas Supreme Court on behalf of the National Association of Bankruptcy Trustees.

The Stanford Ponzi Scheme

The question arose in the $7 billion Ponzi scheme perpetrated by R. Allen Stanford, now serving a 110-year prison sentence. The Securities and Exchange Commission obtained the appointment of a receiver, who brought lawsuits to aid defrauded investors.

Under TUFTA, the receiver sued an investor who took out $79 million in principal shortly before the fraud was exposed, but after news of the SEC investigation had become public. The district court ruled that the investor was the recipient of a transfer made with actual intent to hinder, delay or defraud. The only issue was the investor's good faith defense under TUFTA.

Under TUFTA, the defendant would have no liability if it could prove that it received the transfer "in good faith and for reasonably equivalent value." Good faith was the only issue, because repayment of the investor's principal established reasonably equivalent value.

The parties agreed that the defendant conducted no investigation. The jury was therefore left to decide two questions. First, the jury concluded that the defendant was on inquiry notice regarding the question of good faith. On the second question, however, the jury decided that an investigation would have been futile. A futile investigation was defined in the jury charge as "a

diligent inquiry that would not have revealed to a reasonable person that Stanford was running a Ponzi scheme."

The district court ruled that the defendant was entitled to the good faith defense under TUFTA by having proven that an investigation would have been futile. The receiver appealed.

The First Fifth Circuit Opinion

In January, a three-judge panel of the Fifth Circuit reversed the district court and found the defendant liable. *Janvey v. GMAG LLC*, 913 F.3d 452 (5th Cir. Jan. 9, 2019).

The opinion by Chief Circuit Judge Carl E. Stewart made a so-called *Erie* guess by presuming that the Texas Supreme Court would not recognize the futility defense. Ironically, Judge Stewart said that the same facts would have given the transferee a complete defense were the defendant able to raise the seemingly identical good faith defense under Section 548(c) of the Bankruptcy Code.

The defendant who received the fraudulent transfer filed a motion for panel rehearing and rehearing *en banc*.

The Fifth Circuit's Certified Question

In a *per curiam* opinion in May, the panel granted the motion for panel rehearing and vacated the opinion from January.

In a certified question, the panel asked the Texas Supreme Court to rule on whether a defendant on inquiry notice who did not conduct an inquiry is nonetheless entitled to the good faith defense if inquiry would have been futile. *Janvey v. GMAG LLC*, 925 F.3d 229 (5th Cir. May 24, 2019).

To read ABI's reports on the first and second Fifth Circuit opinions, click here and here.

The Texas Court Is Tough on Recipients of Fraudulent Transfers

The Texas Supreme Court summarized the question and the answer like this: "May a transferee on inquiry notice of a fraudulent transfer satisfy TUFTA's good-faith defense without conducting a diligent investigation? We conclude that the answer is no . . . regardless of whether the transferee reasonably could have discovered the fraudulent activity through diligent inquiry."

The opinion seems based in significant part on policy perceived to underlie TUFTA. For example, Justice Busby said that the uniform act "was created to ensure defrauded creditors attain similar remedies." He also said that "choosing to remain willfully ignorant of any information an investigation might reveal is incompatible with good faith."

In general, Texas law doesn't seem to cut much slack for recipients of fraudulent transfers who have reason to suspect fraud was afoot.

Although TUFTA does not define good faith, Texas courts have ruled that a "transferee must show that its conduct was honest in fact, reasonable in light of known facts, and free from willful ignorance of fraud," Justice Busby said.

Because the jury decided that the defendant was on inquiry notice, Justice Busby said that his court was tasked with deciding "how a transferee with inquiry notice of fraud can prove good faith." Citing *Black's Law Dictionary*, he defined inquiry notice as "'[n]otice attributed to a person when the information would lead an ordinarily prudent person to investigate the matter further.'"

If a diligent inquiry would have uncovered facts showing fraudulent intent, Justice Busby said that "Texas common law imputes knowledge of those additional facts to the transferee as well." Furthermore, a transferee is infected with knowledge "so long as it reasonably could have been discovered at the time of the transfer."

Focusing on the certified question, Justice Busby said that "a transferee seeking to prove good faith must show that it investigated the suspicious facts diligently. A transferee who simply accepts a transfer despite knowledge of facts leading it to suspect fraud does not take in good faith."

But what if a diligent inquiry would not have disclosed fraud? Justice Busby found the answer embedded in the notion of good faith.

Justice Busby said that "choosing to remain willfully ignorant of any information an investigation might reveal is incompatible with good faith . . . . If the transferee fails to demonstrate its good faith and avoid willful ignorance by conducting a diligent investigation, it cannot be characterized as acting with honesty in fact."

Concluding the opinion, Justice Busby held that a "transferee on inquiry notice of fraud cannot shield itself from TUFTA's clawback provision without diligently investigating its initial suspicions — irrespective of whether a hypothetical investigation would reveal fraudulent conduct."

The opinion is *Janvey v. GMAG LLC*, 19-0452, 2019 BL 487782 (Tex. Sup. Ct. Dec. 20, 2019).

Arbitration

econd Circuit says that later Supreme Court authority did not undermine the appeals court's prior decision that creditors cannot compel arbitration of discharge violations.

Second Circuit Nixes Nationwide Class Actions for Discharge Violations

In March 2018, the Second Circuit held that a debtor is not required to arbitrate a contempt action alleging that a creditor violated the discharge injunction. *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).

Two months later, the Supreme Court compelled employees to arbitrate wages and hours claims governed by the Fair Labor Standards Act. *Epic Systems Corp. v. Lewis*, 200 L. Ed. 2d 889 (Sup. Ct. May 21, 2018). *Epic* said that a statute like the FSLA did not manifest a clear intention to override the federal Arbitration Act.

Epic raised the following question: Does the Bankruptcy Code manifest a clear intention to override arbitration agreements, or does bankruptcy for some reason represent an exception to *Epic's* exacting standard?

In an opinion on June 16, the Second Circuit rejected an appeal by lenders contending that *Anderson* is no longer good law after *Epic*. Still, the lenders may have won more than they lost, because the appeals court said in strongly worded *dicta* that the bankruptcy court may not maintain a nationwide class action to rectify violations of the discharge injunction.

New Appeal, Same Facts

Like *Anderson*, the facts before the Second Circuit were simple. Two lenders had charged off the debtors' credit card debt before bankruptcy. After discharges in chapter 7, the lenders continued to report the debts as charged off rather than discharged.

The debtors asserted that failing to report the debts as discharged was an effort to coerce repayment. They reopened their bankruptcy cases and mounted a purported nationwide class action seeking a contempt citation and damages for violating the discharge injunction.

The bankruptcy court denied the lenders' motion to enforce an arbitration clause in the credit card agreements, and the district court affirmed.

Circuit Judge Richard J. Sullivan upheld denial of the motion to compel arbitration, but probably killed off the class action.

The Second Circuit Revisits *Anderson*

Up front, Judge Sullivan said that *Anderson* was controlling and answered "this very question only two years ago." However, the lenders argued that *Epic* undermined both *Anderson* and the Supreme Court authority on which it was based, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987).

The better part of Judge Sullivan's decision was therefore devoted to deciding whether *Anderson* was no longer good law after *Epic* established what he described as an "exacting gauntlet through which a party must run to demonstrate congressional intent to displace the Arbitration Act."

Judge Sullivan quickly cited the Fifth Circuit for holding that *Epic* employed substantially the same test as *McMahon*. *See Henry v. Educ. Fin. Serv.* (*In re Henry*), 944 F.3d 587, 592 (5th Cir. 2019). Like *Anderson*, *Henry* allowed a class action over a discharge violation to proceed despite an arbitration clause. To read ABI's report on *Henry*, click here.

"More to the point," Judge Sullivan said, *Epic* didn't say it was overruling or modifying *McMahon*. He interpreted *Epic* as a "reminder that a statute's purpose cannot circumvent its text." Furthermore, *Epic* "clearly viewed statutory silence as probative evidence that Congress did not intend to displace the Arbitration Act."

Even though the Bankruptcy Code is silent regarding arbitration, Judge Sullivan said the omission was not "outcome determinative." He therefore did "not think that the Code's failure to expressly disclaim arbitrability undermines *Anderson*'s conclusion."

Judge Sullivan conceded that the lenders had "one textual argument with some teeth": State courts have concurrent jurisdiction to enforce discharge injunctions. Given that state courts are competent to decide discharge disputes, the lenders argued that arbitrators are, too.

Judge Sullivan disagreed. In state court, discharge is raised as a defense in debt collection, but the debtors were seeking damages for contempt of the discharge injunction in bankruptcy court, the only court with the right to grant that remedy.

Neither the text of the Bankruptcy Code nor the legislative history were helpful in divining the intent of Congress regarding contempt proceedings, Judge Sullivan said. He therefore upheld denial of the arbitration motion, reiterating "*Anderson*'s conclusion that the Code is in 'inherent conflict' with arbitration."

Dicta on No Class Action

In deciding that the debtor was not obliged to arbitrate a discharge violation, Judge Sullivan said, "we have not endeavored to address whether a nationwide class action is a permissible vehicle for adjudicating thousands of contempt proceedings, and neither our decision today nor *Anderson* should be read as a tacit endorsement of such."

In a nationwide class action, the bankruptcy court would be interpreting other judges' discharge injunctions. Judge Sullivan found "severe tension" with the idea in *Anderson* that the bankruptcy court would be denying arbitration to interpret its own order. He therefore said, "It seems to us that this rationale is anathema to a nationwide class action."

But he didn't stop there. Judge Sullivan questioned whether one bankruptcy court would have jurisdiction to hold a creditor in contempt of another court's order. "Most circuits that have considered the issue have rejected the notion," he said.

Judge Sullivan affirmed the district court but remanded for further proceedings consistent with the opinion, presumably meaning that the lower courts should nix the nationwide class action.

What's Left for Class Actions?

The Second Circuit all but held there can be no nationwide class action. Presumably, a bankruptcy judge could entertain a class suit for discharge violations occurring in cases before that judge.

Could a bankruptcy judge entertain a class suit for discharge violations affecting debtors before different judges in the same courthouse? Or before different judges in the same district?

The decision seems to remove the economic incentive for the plaintiffs' bar to rectify discharge violations on a scale large enough to warrant the expense. All is not lost, however. Plaintiffs' counsel may sometime be able to allege the same facts in a class suit under the Fair Debt Collection Practices Act.

The opinion is *GE Capital Retail Bank v. Belton (In re Belton)*, 19-648 (2d Cir. June 16, 2020).

Are the lower courts out of step with the Supreme Court when it comes to enforcement of arbitration of disputes in bankruptcy court?

Refusal to Arbitrate the Validity of a Security Interest Is Tersely Affirmed in California

Eventually, the Supreme Court will decide whether debtors can be compelled to arbitrate core and non-core disputes with creditors. For now, at least, courts in the Ninth Circuit are giving short shrift to motions to compel arbitration.

In recent years, the Supreme Court has been adamant about enforcing arbitration agreements in nonbankruptcy disputes. In May 2018, the Supreme Court compelled employees to arbitrate wages and hours claims governed by the Fair Labor Standards Act. The court said a statute like the FSLA did not manifest a clear intention to override the Federal Arbitration Act. *Epic Systems Corp. v. Lewis*, 200 L. Ed. 2d 889 (Sup. Ct. May 21, 2018).

When (and if) the issue reaches the Supreme Court, the question will be this: Does the Bankruptcy Code manifest a clear intention to override the Arbitration Act? Certainly, there is nothing in the language of the Code that bars arbitration. Will the Supreme Court enforce arbitration agreements against debtors or find an exception to arbitration in the overall structure, purpose and policy regarding bankruptcy?

Two years after *Epic*, the Second Circuit decided that *Epic* was not controlling and ruled that a debtor is not compelled to arbitrate a claim that a creditor violated the discharge injunction. *GE Capital Retail Bank v. Belton (In re Belton)*, 961 F.3d 612 (2d Cir. June 16, 2020). To read ABI's report on *Belton*, click here.

Similarly, the Fifth Circuit held before *Belton* but after *Epic* that the bankruptcy court has discretion not to enforce an arbitration agreement when a debtor initiated a class action contending that a creditor had violated the discharge injunction. *Henry v. Educational Finance Service (In re Henry)*, 941 F.3d 147 (5th Cir. Oct. 17, 2019). To read ABI's report on *Henry*, click here.

In a California case, an arbitration dispute arose in a chapter 11 case in San Diego. Before bankruptcy, a law firm had been successful in prosecuting a lawsuit on behalf of the debtor. The firm filed a secured proof of claim, saying it had a security interest in proceeds from the judgment.

The debtor objected to the claim, contending that the security interest was invalid or unenforceable. The law firm responded by demanding arbitration under an arbitration clause in the pre-bankruptcy engagement agreement with the debtor.

The bankruptcy court denied the motion to compel arbitration, and the law firm appealed. District Judge Cathy Ann Bencivengo of San Diego affirmed in a four-page opinion on January 20.

According to Judge Bencivengo, the outcome was controlled by the Ninth Circuit's pre-*Epic* decision in *Kirkland v. Rund (In re EPD Investment Co. LLC)*, 821 F.3d 1146 (9th Cir. May 9, 2016). To read ABI's report on *EPD*, click here.

According to Judge Bencivengo, the bankruptcy court's discretion under *EPD* to override an arbitration agreement is governed by three factors: (1) having bankruptcy issues decided in bankruptcy court; (2) the centralization of bankruptcy disputes in bankruptcy court; and (3) avoiding piecemeal litigation.

Judge Bencivengo quickly affirmed denial of arbitration. She said that Bankruptcy Judge Louise D. Adler had not abused her discretion because the application of the facts to the *EPD* factors was neither "illogical, implausible, [n]or without support in the record."

The opinion is *In re Cuker Interactive LLC*, 20-01854, 2021 BL 18267, 2021 Us Dist Lexis (S.D. Cal. Jan. 20, 2021).

Wages & Dismissal

Although Social Security benefits are not subject to the "operation of any bankruptcy or insolvency law," judge says they can be considered in deciding whether someone should be allowed to confirm a chapter 13 plan or have a chapter 7 case dismissed for 'abuse.'

Detroit District Judge Includes Social Security Benefits in the Chapter 13 'Abuse' Test

On a question where the courts are split, a district judge in Detroit upheld Bankruptcy Judge Thomas J. Tucker by ruling that Social Security benefits can be considered in deciding whether a chapter 7 petition should be dismissed for "abuse" under the "totality of the circumstances" test.

Even though Social Security benefits are not included in the chapter 13 calculation of disposable income, District Judge Bernard A. Friedman also said that Social Security benefits could be considered in deciding whether a plan was filed in bad faith.

Full-Payment Chapter 13 Was Possible

The husband and wife debtors were not sympathetic litigants. In his August 18 opinion, Judge Friedman referred to their "outrageous abuse of consumer credit."

The couple had two sources of income: combined Social Security benefits of about $4,000 and a monthly pension of some $1,800, for total monthly income of approximately $5,800. They had no priority claims. Their unsecured debt aggregated about $43,000.

If the debtors had remained in chapter 7, unsecured creditors would receive nothing while the pension income and Social Security benefits would have been insulated from creditors' claims under 42 U.S.C. § 407, which bars the garnishment or attachment of Social Security benefits.

If Social Security benefits were considered, Judge Friedman agreed with Judge Tucker by saying that the debtors would have had about $1,250 left over every month after paying living expenses, including their $900 monthly mortgage and lease payments on two almost-new automobiles. Taking Social Security benefits into consideration, both judges concluded that the debtors could pay their creditors in full over the course of a 41-month chapter 13 plan.

Making the debtors less sympathetic, Judge Friedman noted that their $43,000 in unsecured debt, mostly on credit cards, had been incurred after they discharged $164,000 in debt through a chapter 7 discharge in 2008.

The Motion to Dismiss for 'Abuse'

The U.S. Trustee moved to dismiss the case for "abuse" under Section 707(b)(3). Judge Tucker granted the motion but gave the debtors the option of converting the case to chapter 13. They declined the offer, and the chapter 7 case was dismissed. To read ABI's report on Judge Tucker's opinion, click here.

The debtors appealed, but to no avail.

The outcome of the appeal turned on the question of whether Social Security benefits, otherwise an exempt asset, can be included in the "abuse" determination. The courts are divided.

Social Security benefits are explicitly excluded from the definition of "current monthly income" under Section 101(10A)(B)(ii)(I) and are therefore not considered in calculating whether there is a presumption of abuse under the means test in Section 707(b)(2).

As a result, there was no presumption of abuse that could result in dismissal or importuning the debtors to convert to chapter 13.

Likewise, Social Security benefits are not taken into consideration in the chapter 13 confirmation requirement that the debtors commit all of their "projected disposable income" to creditor payments under the plan. Were they in chapter 13, the debtors argued that their plan would pay nothing to creditors but would be presumptively confirmable under Section 1325(b)(1)(B), because "disposable income" includes only "current monthly income," which does not include Social Security benefits.

Of course, Social Security benefits are exempt assets under state law and under Section 522(d)(10)(A).

The Debtors Lose on 'Totality of the Circumstances'

Lower courts are split on whether Social Security benefits can be considered in deciding whether there is "abuse" under Section 707(b)(3). When there is no presumption of abuse, the statute still allows the court to dismiss if the "totality of the circumstances . . . of the debtor's financial situation demonstrates abuse."

Judge Friedman observed that charitable contributions under Section 707(b)(1) are the only exception to the "totality of the circumstances" in Section 707(b)(3). "Totality" is an expansive

term, he said. If Congress had intended to exclude Social Security benefits, "it could have done so," he said.

Like Judge Tucker, Judge Friedman took guidance from "the leading Sixth Circuit case addressing Section 707(b)(3)(B)." In *In re Krohn*, 886 F.2d 123, 126 (6th Cir. 1989), the appeals court focused on whether the debtor was "needy."

In the case on appeal, Judge Friedman said the debtors were not "needy" because their income exceeded their expenses by about $1,250 a month and could pay off all their unsecured debt in 41 months.

Judge Friedman rejected the notion that 42 U.S.C. § 407 barred the use of Social Security benefits in a chapter 13 plan. Section 407 says that the benefits are not subject to garnishment or attachement, "or to the operation of any bankruptcy or insolvency law."

Judge Friedman said that taking the benefits into consideration in the abuse test does not "subject those benefits to legal process or to the 'operation of any bankruptcy or insolvency law.'"

Judge Friedman also rejected the idea that conversion to chapter 13 would be senseless because they could confirm a plan paying nothing to their unsecured creditors.

On another issue where the courts are split, Judge Friedman decided that Social Security benefits can be "properly considered in determining whether a Chapter 13 plan has been proposed in good faith."

Upholding Judge Tucker, Judge Friedman said it comes down to this: "Plainly, debtors in this case do not deserve a fresh start in light of their outrageous abuse of consumer credit."

The opinion is *Meehean v. Vara* (*In re Meehean)*, 19-46085, 2020 BL 313843, 2020 Us Dist Lexis 149109 (E.D. Mich. Aug. 18, 2020).

Michigan judges disagree about the court's ability to consider Social Security benefits in deciding whether a chapter plan was proposed in good faith.

Courts Deeply Split on Social Security Benefits in the Chapter 13 'Abuse' Test

Addressing several issues where the courts are deeply split, Bankruptcy Judge Thomas J. Tucker of Detroit concluded that Social Security benefits can be considered in deciding whether a chapter 7 petition should be dismissed for "abuse" under the "totality of the circumstances" test.

In a 32-page opinion, Judge Tucker even disagreed with another bankruptcy judge in his district.

No-Asset Chapter 7 vs. Full-Payment Chapter 13

The husband and wife debtors had two sources of income: combined Social Security benefits of about $4,000 and a monthly pension of some $1,800, for total monthly income of approximately $5,800. They had no priority claims. Their unsecured debt aggregated about $40,000. It was a no-asset chapter 7 case.

If the debtors were to remain in chapter 7, creditors would receive nothing while the pension income and Social Security benefits would be insulated from creditors' claims.

If Social Security benefits were considered, however, Judge Tucker calculated that the debtors would have about $1,250 left over every month after paying living expenses, including their $900 monthly mortgage and lease payments on two almost-new automobiles. Taking Social Security benefits into consideration, he deduced that the debtors could pay their creditors in full over the course of a 41-month chapter 13 plan.

The Statutes and the Motion to Dismiss for 'Abuse'

The U.S. Trustee moved to dismiss the case for "abuse" under Section 707(b)(3). In his opinion on January 27, Judge Tucker granted the motion but gave the debtors the option of converting the case to chapter 13.

The outcome of the motion to dismiss turned the question of whether Social Security benefits, otherwise an exempt asset, can be included in the "abuse" determination. The courts are divided.

The debtors had several statutory provisions on their side.

Social Security benefits are explicitly excluded from the definition of "current monthly income" under Section 101(10A)(B)(ii)(I). Consequently, Social Security benefits are not considered in the calculation to determine whether there is a presumption of abuse under the means test in Section 707(b)(2).

As a result, there was no presumption of abuse that could result in dismissal or importuning the debtors to convert to chapter 13.

Social Security benefits are not taken into consideration in the chapter 13 confirmation requirement that the debtors commit all of their "projected disposable income" to creditor payments under the plan. Were the debtors in chapter 13, a plan paying nothing to creditors would be presumptively confirmable under Section 1325(b)(1)(B), because "disposable income" includes only "current monthly income," which does not include Social Security benefits.

The debtors also relied on 42 U.S.C. § 407, barring the garnishment or attachment of Social Security benefits.

Finally, of course, Social Security benefits are exempt assets under state law and under Section 522(d)(10)(A).

For whatever it could be worth, the debtors might not have been able to argue successfully that Social Security benefits were not estate assets, because exemptions only apply to property of the estate, thus possibly implying that Social Security benefits are estate property.

The Debtors Lose on Every Count

Judge Tucker knocked down the debtors' theories, one by one.

Lower courts are split on whether Social Security benefits can be considered in deciding whether there is "abuse" under Section 707(b)(3). Judge Tucker cited a Virginia bankruptcy judge who said it made no sense for Congress to exclude benefits from the presumption-of-abuse test while allowing a judge to use the same benefits and find abuse under the "totality" test.

Judge Tucker decided to consider Social Security benefits because the statute has no "clear and explicit" exclusion of the benefits under the "totality" test. Indeed, he said, Congress knew how to exclude the benefits and did so in several Code provisions. Thus, the lack of a specific exclusion suggested to him that Congress intended to include the benefits under the "totality" test.

Judge Tucker also rejected the debtor's contention that it would be pointless to compel them to convert to chapter 13 because they could confirm a plan paying nothing to unsecured creditors.

Again, the courts are split. Judge Tucker cited the Fifth, Ninth and Tenth Circuits, along with several lower courts, for holding that Social Security benefits are not considered in the good faith analysis. He cited Walter Shapero, a bankruptcy judge in his district who retired in 2016. Judge Shapero held in 2015 that the failure to include Social Security income in calculating plan payments did not constitute lack of good faith under Section 1325(a)(3). *In re Mihal*, 13-54435, 2015 WL 2265790 (Bankr. E.D. Mich. May 6, 2015).

However, the Sixth Circuit had provided some guidance about the "good faith" finding required for confirmation of a chapter 13 plan under Section 1325(a)(3). The appeals court had said that a plan must be "consistent with the debtor's available resources," thus allowing the court to consider a debtor's income "from all sources." *Metro Employees Credit Union v. Okoreeh-Baah (In re Okoreeh-Baah)*, 836 F.2d 1030, 1033, 1032 n.3 (6th Cir. 1988).

Although he did not rule definitively, Judge Tucker decided it was "very doubtful" that the debtors could confirm a plan paying nothing to unsecured creditors, in view of the good faith requirement. Therefore, he said, it was not "pointless" for him to cajole the debtors into chapter 13.

With regard to the insulation of Social Security benefits from attachment under title 42, the courts again are split. Some hold that the anti-assignment statute precludes consideration of the benefits in a good faith analysis.

The Sixth Circuit has not spoken, but Judge Tucker held "that the consideration of Social Security income in the good faith analysis . . . is not contrary to § 407 of the Social Security Act."

Wrapping up his opinion, Judge Tucker held that the "ability of a debtor to repay his or her debts out of future earnings is relevant to the determination of whether there is abuse." Because the debtors could propose a chapter 13 plan paying unsecured creditors in full in 41 months, he concluded that the chapter 7 case "must be dismissed, or, if the debtors so choose, converted to chapter 13."

Questions of Statutory Interpretation

The case raises fundamental questions about statutory interpretation.

Does the plain meaning doctrine always ascribe contrary intent to Congress when a statute is silent about a particular situation? Is statutory silence in itself enough to justify a result, or should the result also consider whether the statute in general terms evidences a congressional policy?

May we assume that Congress drafts statutes to cover every conceivable permutation? Or, does Congress indicate a general policy informing the outcome on a topic like Social Security benefits

by prescribing the result in some but not all possible circumstances? Does a statute's omission of the result under a particular set of facts require the court to reach a conclusion opposite to the outcome when the answer is bluntly stated?

Does statutory silence on a particular circumstance enable a judge to impose her or his own sense of fairness when the statute demonstrates a policy outcome in related areas?

In other words, can there be policies in a statute that will ordinarily prescribe the outcome when the statute is silent about a given set of facts?

The opinion is *In re Meehan*, 19-46085 (Bankr. E.D. Mich. Jan. 27, 2020).

Another judge follows statutory language that didn't achieve the result Congress probably intended.

Courts Remain Split on Allowing Credit Counseling on the Same Day but After Filing

Intending to clear up ambiguity about the deadline for an individual to take a course in credit counseling before filing bankruptcy, Congress amended Section 109(h)(1) in 2010. The debate and ambiguity continue nonetheless.

Bankruptcy Judge Kimberley H. Tyson of Denver decided that a debtor may take the course after filing, so long as the debtor took the course and filed the petition on the same day. Judge Tyson followed the plain language of the statute even though her holding may not have accomplished the result that Congress intended.

The debtor's credit counseling certificate showed that he had completed the course about one hour after the filing of his chapter 7 petition. *Sua sponte*, Judge Tyson addressed the question of whether he was eligible under Section 109.

Before amendment in 2010, Section 109(h)(1) required the debtor to have taken the course "during the 180-day period preceding the date of filing of the petition." As Judge Tyson explained in her September 30 opinion, the courts were split.

The Tenth Circuit Bankruptcy Appellate Panel allowed the debtor to complete the course up to the moment of the filing of the petition. Other courts read the statute to mean that the debtor must have completed the course no later than the day before filing.

Congress amended Section 109(h)(1) in 2010. Now, it requires completing the course "during the 180-day period ending on the date of filing."

Courts remain divided. Some permit taking the course on the same day as filing, but after filing. Others require completing the course before filing.

Judge Tyson elected to emulate Bankruptcy Judge Laura T. Beyer of Charlotte, N.C., who permitted a debtor to complete the course after filing, but on the same day. *In re Tillman*, 17-30037, 2017 BL 73259, 2017 WL 933025 (Bankr. W.D.N.C. March 8, 2017). To read ABI's report on *Tillman*, click here.

Judge Tyson explained the rationales given by courts that require that the course be taken before filing. Among other reasons, they believe that Congress intended for debtors to make informed choices, which could happen only if the course were taken before filing.

On the other hand, like Judge Beyer, Judge Tyson found the amended statute to be unambiguous. She consulted dictionaries to say that "date" means the day when an event occurs, not an exact moment in time.

Permitting the course to be taken after filing, but on the same day, accords with the *Collier* treatise, the most ordinary meaning of "date," and the context. Furthermore, Section 109 is not jurisdictional, Judge Tyson said.

Unlike some other courts, Judge Tyson did not delve into the legislative history because "the language of the statute is plain and unambiguous."

Finally, Judge Tyson was not persuaded by Bankruptcy Rule 1007(c), which requires filing the counseling certificate along with the petition.

Judge Tyson said that the rules may not abridge or modify substantive rights. She therefore followed the plain language of the section by allowing completion of the course after filing, but on the same day.

The opinion is *In re Kuykendall*, 20-14818, 2020 BL 377524, 2020 Bankr Lexis 2684 (Bankr. D. Colo. Sept. 30, 2020).

A former bankruptcy judge, now a district judge, makes important law on involuntary petitions.

Defenses to Preferences Are Considered in Counting an Involuntary Debtor's Creditors

In an involuntary petition, creditors who received voidable transfers may not be counted in deciding whether the alleged debtor has 12 or more creditors. On an issue where lower courts are split, District Judge Robert R. Summerhays of Lafayette, La., ruled that a creditor who received a preference is still counted if the debtor can show that the creditor has a statutory defense to the preference.

Judge Summerhays had been a bankruptcy judge since 2006. He was elevated to the district court bench in September 2018.

One creditor filed an involuntary chapter 7 petition against an individual debtor. In response, the debtor filed schedules showing about 25 creditors. If the debtor indeed had 25 creditors, the court would have dismissed the petition because Section 303(b) requires three petitioning creditors if the debtor has 12 or more creditors.

The involuntary petitioner submitted that at least 15 of the scheduled creditors had received preferences and therefore should not be counted under Section 303(b)(2). That section excludes a creditor who is a "transferee of a transfer that is voidable under section . . . 547 . . . ."

The debtor responded by arguing that the transferees all had ordinary course defenses to a preference under Section 547(c)(2). The bankruptcy court sided with the involuntary petitioner and ruled that the petitioner was only required to make a *prima facie* case showing that a creditor had received a preference. The ordinary course defense would not be considered.

The bankruptcy judge entered an order for relief, and the debtor appealed. Judge Summerhays vacated and remanded in an opinion on January 22.

The involuntary petitioner relied on a 1981 case from Long Island, N.Y., where the bankruptcy court held that a creditor could be excluded from the count if the creditor had received a preference, without considering defenses.

There, the bankruptcy judge reasoned that a creditor with a potential preference would hope to avoid bankruptcy and therefore should be excluded from the count, based on a presumption about congressional intent.

Judge Summerhays was more persuaded by the statutory language, his own logic, and a 1983 bankruptcy court decision from Oklahoma.

By disregarding the defenses, Judge Summerhays said that the New York decision "ignores the text of section 303(b)(2) and section 547(b)." In particular, Section 547(b) says that a transfer is avoidable "[e]xcept as provided in subsections (c) and (i) of this section."

"In other words," Judge Summerhays said, "a preferential transfer is not avoidable . . . and, hence, not subject to exclusion under section 303(b)(2), if one of the Section 547(c) defenses applies to the transfer."

Consequently, Judge Summerhays held that "Section 546(c) defenses must be considered in determining whether to exclude a creditor under section 303(b)(2)." He added that "suppositions and presumptions about policy and congressional intent cannot supplant the express language of the statute."

Judge Summerhays vacated and remanded, with instructions to apply the ordinary course defense in counting whether the debtor had 12 or more creditors.

The opinion is *Williams v. Roos*, 19-01674, 2021 BL 22297 (W.D. La. Jan. 22, 2021).

If a creditor objects to chapter 13 eligibility in good faith, the court may look behind the debtor's schedules to decide whether the debt exceeds the cap.

Claims Subject to *Bona Fide* Dispute Are Included in Deciding Eligibility for Chapter 13

Even if a claim is subject to a *bona fide* dispute, the claim is still included in the calculation to determine whether the debtor has too much debt to be eligible for chapter 13.

The facts would make a nifty final exam question in an introductory bankruptcy course, because the outcome revolves around the definitions of "unliquidated" and "contingent" claims.

The March 16 opinion by the Ninth Circuit Bankruptcy Appellate Panel is useful authority for involuntary petitioners when the debtor claims that the petitioners' claims are contingent or unliquidated.

Disputed Liability on an Unsecured Note

The debtor admitted she had signed a $1 million note to purchase a home. The lender never recorded the mortgage, however. The debtor sold the home without paying the lender.

The lender sued the debtor on the note in state court and filed a motion for summary judgment. The debtor raised several defenses to the motion, including the statute of limitations. The debtor also argued that the lender did not have possession of the note or standing to sue.

Before the state court ruled on the summary judgment motion, the debtor filed a chapter 13 petition.

In her schedules, the debtor listed $30,000 in other unsecured debt. She scheduled the lender as having a disputed, unliquidated, contingent claim of $1,000. The lender filed a proof of claim for $1.75 million, representing the original principal plus accrued interest.

The lender filed a motion to dismiss the chapter 13 case, alleging that the debtor had more unsecured debt than the cap at the time of about $395,000 under Section 109(e). Bankruptcy Judge Robert J. Faris of Honolulu granted the motion and dismissed the case.

The debtor appealed to the BAP, which affirmed in an opinion by Bankruptcy Judge Scott H. Gan.

Definitions of 'Unliquidated' and 'Contingent'

Section 109(e) provides that an individual is eligible for chapter 13 only if he or she "owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than [$395,000]."

The debtor argued that the lender's claim was disputed because she alleged that it was barred by the statute of limitations. Judge Gan pointed out that a disputed claim is still a "claim" under Section 109(e). He went on to say that the section "does not exclude debts which are merely disputed."

Although there had been no determination by the state court about the lender's ability to enforce the note, Judge Gan said that the lender's right to payment was shown by the proof of claim attached to the note. The dispute by the debtor, he said, was "not a sufficient basis to exclude the claim for purposes of § 109(e)."

Next, the debtor contended that the bankruptcy court had no reason to look beyond the schedules listing the claim for $1,000.

When the creditor has raised a good faith objection to eligibility, Judge Gan said, "the bankruptcy court can make a limited inquiry outside of the schedules to determine if the Debtor estimated her debts in good faith, and if not, whether she was eligible for chapter 13 relief."

It "appeared to a legal certainty," Judge Gan said, that the lender's claim was not $1,000. He added that the dispute in state court was about the lender's right to enforce the claim, not the amount of the claim. Therefore, the bankruptcy court was entitled to look beyond the schedules.

Next, Judge Gan addressed contingency.

The debtor argued that the debt was contingent because the state court had not ruled on the debtor's liability. No, no, said Judge Gan. The claim was not contingent because "all of the events giving rise to Debtor's liability on the note arose pre-petition."

The debtor also lost her argument that the claim was unliquidated. Again, Judge Gan disagreed. The BAP's precedent says that a claim is liquidated if it "is subject to ready determination."

Judge Gan said that disputed contractual claims are "generally liquidated." Even if the debtor disputes liability, the claim is liquidated if it "is calculable with certainty," citing Ninth Circuit precedent.

In the case at hand, Judge Gan said that the amount of the claim was liquidated and properly included in the Section 109(e) analysis because it was "readily determinable by reference to the note."

The opinion is *Fountain v. Deutsche Bank National Trust Co. (In re Fountain)*, 612 B.R. 743 (B.A.P. 9th Cir. March 10, 2020).

Courts are split on whether large medical bills are consumer debts that invoke the means test and can bar relief in chapter 7.

Large Medical Bills Held Not to Be 'Consumer' Debts

A $300,000 debt for life-saving, emergency medical treatment was not a "consumer" debt because it was not "voluntarily" incurred, according to Bankruptcy Judge C. Kathryn Preston of Columbus, Ohio.

A patient presented himself at the emergency room with fever and difficulty breathing. He was diagnosed with severe pneumonia. At first, he refused admission, until he was told he would die within hours.

The patient was in the intensive care unit for six weeks, including two weeks on a ventilator. The patient underwent physical therapy for an additional three months. For his stay in the ICU, the hospital billed about $300,000.

The patient filed a chapter 7 petition, but the U.S. Trustee filed a motion to dismiss under Section 707(b), contending that the debtor's debts were "primarily consumer debts," raising a presumption of abuse. The debtor filed a motion for summary judgment to dismiss the U.S. Trustee's motion.

Focusing on the facts, Judge Preston said that the $300,000 in medical bills represented almost 75% of the debtor's debts. In his petition, the debtor had characterized his debts as being primarily "medical."

In her February 12 opinion, Judge Preston concluded that the debts were not "primarily consumer" and granted summary judgment in favor of the debtor.

The case turned on the definition of "consumer debt" in Section 101(8). The section describes "consumer debt" as debt that is "incurred by an individual primarily for a personal, family, or household purpose."

In two cases, the Sixth Circuit interpreted "consumer debt" to require "volition," Judge Preston said. Debts not incurred voluntarily, according to the circuit, include tax liens and tort judgments. Unlike consumer debts, which arise from consumption, tax debts result from income, and consumer debts normally arise from extensions of credit, according to the appeals court.

Judge Preston had "no doubt" that "most medical debts are considered consumer debts, as most are incurred voluntarily," such as routine medical visits and cosmetic surgery. However, she cited federal and state laws that require hospitals to provide emergency treatment regardless of a patient's ability to pay.

The U.S. Trustee made two arguments. First, according to the government, the debtor incurred the medical bills voluntarily because he consented to treatment. Nonetheless, Judge Preston said that "an act that leads to indebtedness may be undertaken voluntarily but the attendant debt may result involuntarily and *is not the type of debt that a debtor would expect to incur in his daily affairs*." [Emphasis added.]

Second, the U.S. Trustee argued that the debt was consumer in nature because it was incurred "for a personal purpose."

In response, Judge Preston said that almost all debts "have some kind of personal, family, or household purpose, even those incurred with an eye for profit . . . , but this does not make it a 'consumer debt.'"

Judge Preston concluded that the medical debts were not voluntarily incurred because the debtor "did not intend to have a near death experience" and spend six weeks in the ICU. She said the medical bills were "more akin to judgment from a tort action, in which some sort of accident occurs and the debtor is found liable for the unforeseen damages."

Observations

Courts are split on whether large medical debts qualify as consumer debts. In an opinion on November 19, Bankruptcy Judge Mary P. Gorman of Springfield, Ill., ruled that $82,000 in medical bills in excess of insurance coverage were consumer debts even though they were involuntary in nature. *Zgonina*, 19-90467, 2019 BL 445060, 2019 Bankr. Lexis 3571 (Bankr. C.D. Ill. Nov. 19, 2019). For ABI's report on *Zgonina*, click here.

This writer submits that focusing on the voluntary nature of debt does not advance the inquiry. Even in the case of an accidental tort, there will be an element of "voluntariness." For example, an individual causing an auto accident intended to drive the car but did not intend the consequences. How much "voluntariness" is required before a debt is "consumer?" Where should the court draw the line?

Like Judge Preston, who focused on the debtor's expectations, perhaps courts should employ an objective test, inquiring whether someone would expect to incur a particular type of debt in the normal course of family life. Consumers expect to incur debt for cars or to purchase and outfit homes. But no one expects to incur large medical debt. No one expects to cause an accident. No one expects to incur large tax debts, which also have been held to be non-consumer.

People make mistakes, and bad fortune can befall. That's human nature. Mistakes and bad fortune can end up saddling an individual with large debts. Should someone be subjected to a five-year chapter 13 plan on account of a mistake or bad fortune?

Bankruptcy law has other means for dealing with circumstances where the debtor is not blameless. For example, an intentional tort can result in nondischargeability, and tax debts can be nondischargeable. Even if an individual has nondischargeable debts, why also deny access to chapter 7?

Perhaps normal expectations should weigh heavily in deciding whether a debt is consumer in nature. People who are subjected to bad fortune should not also be subjected to chapter 13.

The opinion is *In re Sijan*, 611 B.R. 850 (Bankr. S.D. Ohio Feb. 12, 2020).

Plans & Confirmation

The Seventh Circuit opinion raises the question of whether (or when) a court may restrict the use of a provision in a chapter 13 plan that Section 1322(b) permits.

Seventh Circuit Requires Court Findings for a Plan Provision the Code Allows

The Seventh Circuit, per Circuit Judge Frank Easterbrook, has issued the third in a series of opinions emphatically requiring bankruptcy courts to make case-specific findings of fact when a chapter 13 plans calls for assets to be retained in the estate until the entry of discharge.

The new decision from the Chicago-based appeals court raises the question of whether courts may impose limitations on the inclusion of provisions in a chapter 13 plan that Section 1322(b) permits. The Seventh Circuit evidently believes courts have that power, even when the plan satisfies the statutory requirements for confirmation.

Chicago Parking Ticket Cases

The latest opinion on July 6 again deals with the quest by the city of Chicago to collect parking fines from individuals who file bankruptcy. Parking fines are important because Chicago generates about 7% of the city's annual income from parking fines and traffic tickets.

Chapter 13 debtors in Chicago had been routinely confirming plans that would retain assets in the estate after confirmation. Before the Seventh Circuit began handing down its decisions, the city could not tow and impound a car with outstanding parking fines since a car would be an estate asset protected by the automatic stay in Section 362.

Revesting in the debtor entails the loss of significant protection because a revested asset is no longer sheltered by the automatic stay. Retaining assets in the estates continues the protection of the automatic stay until discharge.

Retaining estate assets in the estate after confirmation is permitted by statute. Section 1322(b)(9) provides that a plan may "provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity." Part 7 of the national form of a chapter 13 plan allows a debtor to check a box about the revesting of assets. One box revests on confirmation and the other on the entry of discharge.

The Trilogy of Seventh Circuit Decisions

The progression of decisions in the Seventh Circuit went like this: First, the appeals court held in *In re Steenes*, 918 F.3d 554 (7th Cir. March 14, 2019) ("*Steenes I*"), that bankruptcy courts may not, as a general practice, approve chapter 13 plans providing for debtors' cars to remain estate property after confirmation.

In *Steenes I*, Judge Easterbrook said the bankruptcy judge must enter a "case-specific order, supported by good case-specific reasons," to retain an asset in the estate after confirmation. *Id.* at 558. To read ABI's report on *Steenes I*, click here.

Because the appeals court had not answered one of the questions on appeal in *Steenes I*, the Seventh Circuit granted panel rehearing and reversed the two lower courts in November on the additional question of administrative priority. *In re Steenes*, 942 F.3d 834 (7th Cir. Nov. 12, 2019) ("*Steenes II*"). To read ABI's report, click here.

In *Steenes II*, Judge Easterbrook held that vehicle fines on an estate-retained car are administrative expenses that must be paid in full. If not paid, the chapter 13 case can be dismissed or the debtor may be denied a discharge even if all other plan payments were made.

While *Steenes II* was pending, two other Chicago parking ticket cases were percolating to the court of appeals and would become the third opinion by Judge Easterbrook on July 6.

The Third Opinion

The third appeal dealt with a pair of confirmation hearings held five days after *Steenes I*. Judge Easterbrook characterized the bankruptcy judge as interpreting the statute to allow "debtors to keep assets in the estate without reasons." According to Judge Easterbrook, the bankruptcy judge "added that the judiciary need not justify approval of a plan reflecting a debtor's choice."

When the two plans were confirmed, the city appealed. The circuit court accepted a direct appeal.

In the third appeal, Judge Easterbrook set aside the confirmation orders in both cases. Whether the debtor checks a box in the plan to retain assets or the bankruptcy court uses a form order, he said "there must be a good case-specific reason for" not having the assets revest in the debtor on confirmation.

Judge Easterbrook added, "a desire to obtain free parking . . . is not a good reason."

Observations

Questions: Does the new opinion require specific findings about all estate assets or only automobiles? What reason is good enough? Is it proper to retain assets in the chapter 13 estate to prevent attachment by creditors with nondischargeable claims? Will other circuits agree?

Although the issue was briefed, the appeals court did not discuss the significance of Section 1322(b)(9), which allows a plan to call for revesting sometime after confirmation.

In the Seventh Circuit, it appears that the court must make specific findings of fact regarding an alternative that the statute gives debtors with regard to the revesting of assets. Although the statute lays out no guidelines for the adequacy of the debtor's reason about revesting other than the general good faith test, the new opinion is calling on courts to establish standards.

One wonders: How many other permissible provisions in a plan will require bankruptcy courts in the Seventh Circuit to make specific findings of fact alongside confirmation?

This writer is aware that bankruptcy courts in some other circuits allow revesting to occur on the entry of discharge. Perhaps there will be a circuit split one day.

The latest decision from the Seventh Circuit raises the question of whether courts may impose restrictions on the invocation of plan provisions that Section 1322 (b) allows. The case could also be understood to mean that bankruptcy courts in some circumstances must make findings of fact when there is no objection. *Cf. United Student Aid Funds Inc. v. Espinosa*, 559 U.S. 260 (2010), where the Supreme Court suggested that a bankruptcy court should not confirm a plan that violates a provision in the Bankruptcy Code even in the absence of objection.

The opinion is *In re Cherry*, 19-1534 (7th Cir. July 6, 2020).

Judge Shefferly writes a complicated opinion on the retroactivity of the HAVEN Act to cases filed prior to enactment.

HAVEN Act May Be Employed to Reduce Payments Under a Confirmed Chapter 13 Plan

In August, Congress adopted the so-called HAVEN Act, which allows military veterans to exclude disability benefits from the calculation of "current monthly income." In practical terms, the new law means that veterans will no longer be compelled to pay a portion of their disability benefits to creditors under chapter 13 plans.

Chief Bankruptcy Judge Phillip J. Shefferly of Detroit decided on March 10 that the HAVEN Act allows veterans to modify confirmed chapter 13 plans by reducing payments to creditors.

Judge Shefferly's holdings are more nuanced, so bear with us while we lay out the background and drill down on his rulings.

The Debtor's Plan and Finances

The debtor filed a chapter 13 petition in December 2018 and confirmed a plan in March 2019 with a 100% distribution to unsecured creditors. The debtor was paying her mortgage directly alongside $600 a month paid to the trustee.

In October 2019, the debtor filed a proposed modification to her plan that would reduce her payments to $500 a month. The modified plan would reduce the recovery by unsecured creditors.

The debtor justified the plan modification by filing amended schedules eliminating some $1800 in monthly veteran's disability benefits from her disposable income.

The trustee objected to approval of the modified plan, contending that the debtor should not be allowed to invoke the HAVEN Act retroactively and deduct disability benefits from the calculation of disposable income.

The HAVEN Act

In the amendments to the Bankruptcy Code in 2005, Section 101(10A) broadly defined "current monthly income" to include income from all sources. The subsection as it then read had several specific exclusions, such as Social Security benefits and payments to victims of domestic terrorism. However, disability payments to military veterans were not excluded.

As Judge Shefferly said in his 16-page opinion, current monthly income is the "building block" for determining eligibility for chapter 7 and a debtor's right to confirm a plan in either chapter 11 or 13.

Aiming to rectify mistreatment of members of the military who were injured on died in service to the country, Congress adopted the Honoring American Veterans in Extreme Need Act, Public Law No. 116-52, 133 Stat. 1076, commonly known as the HAVEN Act. Judge Shefferly said the Act was intended to treat veterans' "benefits the same as Social Security benefits by excluding them from [current monthly income] and, therefore, from an individual debtor's projected disposable income."

From the calculation of current monthly income, Section 101(10A)(B)(ii)(IV) now excludes "monthly compensation, pension, pay, annuity, or allowance paid under title 10, 37, or 38 in connection with a disability, combat-related injury or disability, or death of a member of the uniformed services . . . ."

The HAVEN Act became law on August 23, 2019, but did not by its own terms state whether the new definition of current monthly income would apply to pending cases.

Judge Shefferly identified three issues regarding the application of the Act to pending cases.

The Act Applies to Pending Cases

Judge Shefferly first addressed the question of whether the Act applies only to cases filed after enactment. He cited Supreme Court authority for the proposition that a court applies the law in effect at the time of rendering a decision unless "doing so would result in manifest injustice." *Bradley v. School Board of Richmond*, 416 U.S. 696, 711 (1974).

Judge Shefferly found no manifest injustice in applying the law to pending cases. Indeed, he said the legislative history "strongly suggests" there would be manifest injustice if the new law were not immediately applicable to remedy an "obvious inequity."

Finding nothing in the Act, the legislative history, or the official forms indicating that the new law should be applied only to cases filed after enactment, Judge Shefferly held that he would apply the HAVEN Act as "the law in effect at the time that the Court will render its decision."

Is HAVEN Retroactive?

Supreme Court authority includes a presumption against retroactivity absent a clear congressional intent to the contrary. *Landgraf v. USI Film Products*, 511 U.S. 244 (1994).

Given that Congress did not explicitly make the Act retroactive, Judge Shefferly analyzed whether retroactivity "would impair the rights that a party possessed when they acted."

Judge Shefferly decided it would be "fundamentally unfair" were he to apply the Act by deducting the debtor's disability benefits and unraveling confirmation. In other words, he said that "'retroactive' application of the HAVEN Act to confirmation of the Debtor's plan is not permitted."

The Debtor May Employ HAVEN to Modify the Plan

Although the debtor may not employ the Act retroactively to set aside confirmation, may the debtor nevertheless rely on the Act to modify her plan? In other words, does the new statute provide grounds to modify the plan, even though the Act does not apply retroactively?

Section 1329 allows a plan to be modified after confirmation. On an issue where the courts are split, the Sixth Circuit Bankruptcy Appellate Panel has held that the ability to modify a plan does not require an unanticipated or substantial change in the debtor's circumstances.

The BAP, however, takes something of a middle ground by precluding modification, as Judge Shefferly said, of "issues that were or could have been decided at the time the plan was originally confirmed." *Storey v. Pees (In re Storey)*, 392 B.R. 266, 272 (B.A.P. 6th Cir. 2008).

Surely, Judge Shefferly said, the adoption of the Act was "not something that the Debtor or the Trustee could have anticipated when the Debtor's plan was confirmed." He found "nothing unfair" about employing the Act to modify the plan when the creditors were all given notice and none objected.

In fact, Judge Shefferly said that precluding the debtor from taking advantage of the HAVEN Act "would be to shackle the Debtor going forward to a policy . . . that Congress has expressly rejected as an "'obvious inequity.'"

Judge Shefferly allowed the debtor to modify the plan.

The opinion is *In re Gresham*, 18-56289, 2020 BL 88574, 2020 Bankr Lexis 627, 2020 WL 1170712 (E.D. Mich. March 10, 2020).

The Ninth Circuit allows chapter 13 debtors on their own to accelerate payments to creditors and secure their discharges more quickly without modifying their plans.

Reversing the BAP, Ninth Circuit Allows Chapter 13 Plans with Estimated Durations

Reversing the Bankruptcy Appellate Panel, the Ninth Circuit ruled that the bankruptcy court must confirm a chapter 13 plan with an *estimated* duration, so long as no creditor objects and all other confirmation requirements are satisfied.

The June 22 opinion is important because it permits debtors to accelerate payments and receive their discharges more quickly, and in the process avoid paying more to creditors than required. The decision also allows an accelerated exit from chapter 13 without obliging debtors to modify their plans under Section 1329.

The Old and New Model Plans

Previously, a model plan in a division of the Northern District of California permitted chapter 13 plans with estimated durations. In 2016, the judges in the division required debtors to use the district's model plan, which called for plans with fixed durations.

Four debtors proposed plans that modified the model plan by having an estimated duration. In the four cases, unsecured creditors were to receive no recoveries. With only estimated durations, the debtors could accelerate payments and receive their discharges as soon as their payments were sufficient to cover administrative expenses, priority claims, and secured claims.

The chapter 13 trustee did not object to the plans.

The bankruptcy court nonetheless refused to confirm the plans, holding that fixed terms were required and that the debtors had not proposed their plans in good faith. The BAP upheld the bankruptcy court, telling the debtors they must modify their confirmed plans to receive discharges more quickly.

The bankruptcy court confirmed the plans after the debtors modified them to included fixed terms. The debtors appealed again, this time to district court. The district court certified a direct appeal, which the circuit accepted.

The Code Doesn't Require Fixed Terms

In a 33-page opinion, Circuit Judge Patrick J. Bumatay reversed the BAP. With fixed terms for their plans, he said the debtors would "be stuck in bankruptcy for the length of the fixed period, even if they pay off all listed priority and secured debts before that period elapses."

Although unsecured creditors were not entitled to any payments, Judge Bumatay said that one of the debtors was required by the fixed duration of the plan to pay $1,000 to unsecured creditors. In other words, a plan with fixed duration can compel a debtor to pay more than was necessary to confirm the plan in the first place.

Turning from practical considerations to the statute, Judge Bumatay found "no express provision of Chapter 13, even when viewed in the context of its broader structure, [that] prohibits plans with estimated lengths."

First, Judge Bumatay noted that Section 1322(b)(11) allows a plan to contain provisions not inconsistent with chapter 13. Next, he found only two statutory provisions that informed the issue.

Section 1322 imposes three- and five-year maximum durations for plans of debtors who are above or below the median. Section 1325(b)(4) imposes a fixed minimum duration of a plan, but only if there is an objection.

Thus, Judge Bumatay said, "Neither § 1322 nor § 1325 point to an express fixed or minimum duration requirement for Chapter 13 plans absent an objection . . . . Indeed, § 1325(b)(1)(B)'s explicit imposition of a minimum duration only when an objection is raised strongly suggests that the absence of such fixed terms in other sections of Chapter 13 was intentional."

Given the "clear implication" of the statute, Judge Bumatay held that "the Code provides no minimum fixed durations." Section 1322(b)(11), he said, "permits a debtor to add an estimated term provision, so long as the plan does not draw an objection." On the other hand, "the BAP read a prohibition where none exists."

Moving beyond the statute, Judge Bumatay considered policy reasons advanced by the BAP for always requiring plans with fixed terms. In that regard, the BAP relied on the intent of the 2005 amendments to require debtors to pay as much as they can.

Judge Bumatay found other policies in chapter 13, such as allowing honest debtors to have a fresh start. Given the "wide array" of purposes in the Bankruptcy Code, he said that "we hew to the statute's language and structure, neither of which prohibits estimated term provisions."

Finally, Judge Bumatay vacated the bankruptcy court's findings that the plans were not proposed in good faith. He said the lower courts "relied on their erroneous interpretation of the

Code to determine that the Debtors lacked good faith." Furthermore, he said, "Debtors do not lack good faith 'merely for doing what the Code permits them to do,'" quoting *In re Welsh*, 711 F.3d 1120, 1131 (9th Cir. 2013).

There was no appellee. The chapter 13 trustee submitted an *amicus* brief in support of the debtors.

The opinion is *In re Sisk*, 18-17445 (9th Cir. June 22, 2020).

Detroit's Judge Randon holds that a chapter 13 plan's five-year duration begins to run from the first payment, not from confirmation.

District's Model Chapter 13 Plan Violates the Code by Requiring More than 60 Payments

Bankruptcy Judge Mark A. Randon of Detroit ruled in substance that his district's model chapter 13 plan violates the "plain language" of Section 1322(d)(1) by requiring payments for more than five years.

Taking sides with the majority of courts, Judge Randon held that a chapter 13 debtor's five-year commitment period begins to run from the first payment, not from confirmation.

The couple were debtors with income above the median, giving them a five-year commitment period. Their chapter 13 plan was scheduled for confirmation about 14 months after filing. As required, the couple had begun making payments within a month of filing.

The debtors proposed to modify the district's model plan by providing that the 60-month commitment would begin to run with their first payment, not on confirmation. The chapter 13 trustee objected, arguing that the debtors could not modify the duration provision in the district's model plan.

The difference was significant. If the commitment period began on confirmation, they would be making payments for 74 months, not 60.

In his September 11 opinion, Judge Randon said that the district's model plan had been adopted after receiving comments from the public and chapter 13 trustees, informed by "the Court's historical experience with previous model plans."

The trustee contended that the effective date of the plan dictates when the applicable commitment period begins. However, Judge Randon said that "effective date" and "commitment period" are "separate concepts − neither of which controls the other."

For debtors with income above the median, Section 1322(d)(1) provides that "the plan may not provide for payments over a period that is longer than 5 years," and Section 1326(a)(1) makes the first payment due within 30 days of the order for relief or the filing of the plan, "whichever is earlier."

Judge Randon cited bankruptcy judges from around the country holding that the commitment period begins with the first payment, not on confirmation. He recognized that some courts make the commitment period begin on confirmation, but he said he "disagrees."

Based on the "plain language of the statute," Judge Randon held that the debtors must contribute all of their disposable income "into the plan for five years beginning 30 days after the petition date."

Judge Randon said he did not have authority to "vacate . . . the language of the model plan." Nonetheless, he overruled the trustee's objection by following the "plain language of the statute and start[ing] the commitment period 30 days after the petition date when the first plan payment was due under Section 1326(a)(1)."

Observation

Debtors in Detroit with confirmed plans should be entitled to modify their plans under Section 1329(a)(2) by reducing their payments to 60 months, if the other five judges in the district agree with Judge Randon. Stay tuned!

The opinion is *In re Kinne*, 19-49692 (Bankr. E.D. Mich. Sept. 11, 2020).

Below median debtors are no longer required to turn over tax refunds in excess of $2,000.

Fifth Circuit Invalidates Local Chapter 13 Plan Regarding Tax Refunds

For debtors with incomes below the median, the Fifth Circuit invalidated a local rule requiring all chapter 13 debtors to turn over income tax refunds in excess of $2,000 for distribution to creditors as additional disposable income.

The appeals court said that the local rule was invalid because it conflicted with Section 1325(b) as explicated by the Supreme Court in *Hamilton v. Lanning*, 560 U.S. 505 (2010).

The District's Chapter 13 Plan

Debtors must use the Official Form for chapter 13 plans unless the district has adopted its own local form. *See* Bankruptcy Rule 3015.1. The Western District of Texas adopted its own form plan with a provision requiring all chapter 13 debtors to turn over income tax refunds in excess of $2,000 for distribution by the chapter 13 trustee as additional disposable income. Debtors were allowed to retain excess refunds only if the plan called for paying unsecured creditors 100%.

The chapter 13 trustee said that many districts around the country have similar provisions in their local plans.

In the case that went to the Fifth Circuit, the debtor anticipated receiving a refund of about $3,200. She filed a plan that deleted (that is, struck out) the local form provision calling for turnover of refunds of more than $2,000. She claimed that the refund would be offset by her expenses.

When the bankruptcy court denied confirmation, the debtor filed an amended plan that included the local provision. To ameliorate the effect of the turnover, the confirmation order said that the debtor could pay the $1,200 excess refund to the trustee at the rate of $25 per month for the remaining life of the plan.

The debtor appealed, but the district court affirmed. The debtor appealed again, this time overturning the local plan provision in an opinion on August 26, by Circuit Judge Edith Brown Clement.

Lanning Precludes Mandatory Turnover

Citing Fifth Circuit authority, Judge Clement said that local rules adopted by districts must be procedural only and may not abridge substantive rights.

Did the requirement for turning over tax refunds of more than $2,000 abridge the debtor's substantive rights? Judge Clement found the answer in Section 1325(b)(1)(B) and *Lanning*.

When there has been an objection to the plan, *Lanning* explained how Section 1325(b)(1)(B) requires that all of the debtor's "projected disposable income" be applied toward the claims of unsecured creditors. Although "projected disposable income" is not defined, "disposable income" means "current monthly income" less "amounts reasonably necessary" for the debtor's maintenance and support. "Current monthly income" refers to the six months before filing.

For Judge Clement, the question was whether the excess tax refund represented "projected disposable income."

Judge Clement explained that *Lanning* made a distinction between debtors with income above the median and those below median.

For debtors below the median like the debtor on appeal, the high court said that all amounts reasonably necessary for maintenance and support are not part of disposable income. For an above median income debtor, only specified expenses are deducted.

Judge Clement therefore held that "Section 1325(b)(2) of the Code, as clarified in *Lanning*, plainly allows below-median income debtors to retain any income that is reasonably necessary for their maintenance and support."

Judge Clement rejected the trustee's argument that a uniform rule for all chapter 13 debtors promoted efficiency. She said that efficiency "is not grounds for abridging below-median income debtors' substantive rights to use their 'excess' refund income to finance reasonably necessary expenses for their maintenance and support."

Looking at the debtor's income and expenses, Judge Clement said it was "entirely plausible that [the] Debtor will use her 'excess' tax refund of [about $1,200] for expenses that are reasonably necessary for her family's maintenance and support." Leaving the question open, she invalidated the provision in the local plan mandating the turnover of excess tax refunds, vacated the confirmation order, and remanded the case for the debtor to file a plan consisted with the circuit's decision.

Observations

The language of the opinion appears to invalidate the local plan provision entirely. However, the analysis by Judge Clement showed defects only with regard to below median income debtors.

Could the district adopt a local rule requiring turnover of excess tax refunds by above median debtors?

The opinion does not seem to mean that below median income debtors can always retain tax refunds. The opinion puts the onus on chapter 13 trustees. After a debtor discloses his or her tax return, trustee can pursue a plan modification if the trustee believes that some of the refund is not necessary for maintenance and support.

In other words, the opinion ends the presumption that excess tax refunds belong to creditors and helps debtors who could not afford to pay counsel fees required for proving an entitlement to retain tax refunds. The opinion should mean that debtors will not end up paying too much just simply because they couldn't afford counsel fees.

The opinion is *Diaz v. Viegelahn (In re Diaz)*, 19-50982, 2020 BL 326024, 2020 Us App Lexis 27316 (5th Cir. Aug. 26, 2020.)

In the first court of appeals decision on the topic, the Eleventh Circuit holds that the chapter 13 trustee alone has power to assume a lease or contract.

Eleventh Circuit Holds that a Chapter 13 Plan Alone Can't Assume a Lease or Contract

The first court of appeals to tackle the issue, the Eleventh Circuit held that a chapter 13 plan by itself cannot assume an executory contract.

In an opinion on June 3 by Circuit Judge Kevin C. Newsom, the appeals court held that an executory contract or unexpired lease is only assumed on motion by a chapter 13 trustee. Confirmed for a seat on the Eleventh Circuit in August 2017, Judge Newsom was Articles Editor for the *Harvard Law Review*. After clerking on the Ninth Circuit, he clerked on the Supreme Court for Justice David H. Souter.

Simple Facts, Difficult Questions

Simple facts give rise to difficult questions of statutory interpretation: Utilizing Section 1322(b)(7), the chapter 13 debtor proposed and confirmed a plan providing for the assumption of a lease of personal property. The subsection provides that a chapter 13 plan "may" provide for assumption or rejection of a contract or lease, "subject to section 365."

The plan also called for curing arrears on the lease through payments by the trustee. Going forward, the debtor would make monthly payments.

The debtor defaulted after confirmation, prompting the lessor to file a motion for the allowance and payment of an administrative expense claim for the missed payments.

Affirmed in district court, the bankruptcy court denied the motion, holding that the lease was not assumed because it had not been assumed by the chapter 13 trustee under Section 365(d)(2), which provides that a "trustee" in chapters 9, 11, 12 and 13 may assume or reject an executory contract.

If a lease of personal property is "rejected or not timely assumed by the trustee under [Section 365(d)]," Section 365(p)(1) says that the lease is no longer property of the estate and "is automatically terminated." Because the lease was automatically terminated under Section 365(p)(1), the lower courts held there was no benefit to the estate and thus no administrative claim.

Plain Language Wins Again

Judge Newsom said that the treatises are split on whether a chapter 13 plan alone may assume a contract or lease. *Collier* believes that the plan alone is sufficient, while the Homer Drake treatise says there is no assumption except on motion by the trustee. The *Norton* treatise says "it is not clear" who has the power to assume.

Judge Newsom framed the question this way: Can the debtor, as part of a chapter 13 plan, "singlehandedly and, in particular, without any action by the trustee — obligate the bankrupt estate?" He upheld the lower courts by holding that the word "trustee" in Section 365(p)(1) "means the trustee — and, accordingly, that if the *trustee* does not assume an unexpired lease, it drops out of the debtor's bankruptcy case." [Emphasis in original.]

Judge Newsom said that Section 1322(b)(7) "doesn't answer that question," because it only says what a plan may contain. However, he said it "points" to Section 365(d)(2), which says that "the trustee" in chapter 13 may assume. In addition, Section 1322(b)(7) says that assumption in a plan is "subject to section 365."

Judge Newsom found the answer "conclusively" in the "plain language" of Section 365(p)(1), which says that a lease of personal property is "automatically terminated" if "not timely assumed by the trustee." In other words, the lease "drops out of the estate" when "the trustee does not assume an unexpired lease."

Judge Newsom rejected the lessor's contention that the word "trustee" should be read to subsume a chapter 13 debtor and a chapter 13 plan. He found no room to modify the statute. Furthermore, he said, obligating the estate is "a big deal." It therefore "makes good sense to require the trustee [as representative of all creditors] to affirmatively assume an unexpired lease."

Summing up, Judge Newsom held that Section 365(p)(1) is "crystal clear" and "means what it says." Not assumed by the trustee, the lease dropped out of the estate. Given no benefit to the estate, the claim for an administrative priority was properly denied.

Observations

The opinion may hurt the lessor in more ways than one. Although it does not say so directly, the opinion could be read to suggest that the lessor's claim for post-confirmation arrears is a prepetition general, unsecured claim under the plan. In other words, the lessor provided value after confirmation but would be paid only pennies on the dollar under the plan. What's wrong with that picture?

Has Judge Newsom opened the door for chapter 13 debtors to hornswoggle lessors?

The debtor wouldn't get away with it in the Seventh Circuit, where the appeals court recently held that failure to pay parking tickets after confirmation of a chapter 13 plan is an administrative expense. *In re Steenes*, 942 F.3d 834 (7th Cir. Nov. 12, 2019). For ABI's report on *Steenes*, click here.

In chapter 13, unlike chapter 11, only the debtor may propose a plan. Since Section 1322(b)(7) says that a plan may include the assumption of contracts and leases, does that imply that the debtor by himself or herself can accomplish an assumption?

True, Section 1322(b)(7) says that the plan may assume a contract, but "subject to section 365."

However, Section 365 mostly provides protections for the lessor, such as adequate assurance of future performance. Why can't the requirements of Section 365 be shown at the confirmation hearing? What's the advantage of requiring a motion by the trustee where the court would consider the same issues in a confirmation hearing? Given that the lessor will have had notice of the plan and the confirmation hearing, what's to be gained by requiring an additional motion by the trustee?

If the trustee must file a motion to assume, then why does the statute allow assumption in a plan? The trustee cannot file a plan. There would never be an occasion for assuming a lease in a plan if it had been assumed already on motion by the trustee. The Eleventh Circuit's opinion renders Section 1322(b)(7) useless.

Why not employ common sense rather than attempt to tease the answer out of a poorly written statute? The country's best lawyers become judges, so why not let them use their brains when Congress obviously didn't prescribe the issue? And don't say that judges would be legislating. Undoubtedly, on questions like this they would fashion answers consistent with policies evident throughout the Bankruptcy Code.

Also, what about the effect of confirmation of the plan? Judge Newsom did not discuss *United Student Aid Funds Inc. v. Espinosa*, 559 U.S. 260 (2010), nor did either side brief the issue.

In *Espinosa*, the chapter 13 debtor confirmed a plan that discharged student loans, in violation of the debtor's obligation to file an adversary proceeding and obtain a declaration that the student loans were dischargeable under Section 523(a)(8). Although the plan violated Section 523(a)(8), Justice Thomas ruled for the unanimous Court that the student loans were nevertheless discharged because the plan was final and not subject to collateral attack.

Presumably, the lessor in the Eleventh Circuit had notice of the plan and its assumption of the unexpired lease. Under *Espinosa*, wasn't the plan binding on the lessor, and wouldn't it preclude a collateral attack months after the confirmation order became final?

This area in general is a mess. Congress needs to give better definition to the rights of a chapter 13 debtor. For instance, courts disagree over a chapter 13 debtor's standing to pursue an avoidance action.

The clarification task is difficult, because a chapter 13 debtor is not the same as a chapter 11 debtor in possession, where Congress easily could say in Section 1107(a) that the DIP has the powers of a trustee.

The opinion is *Microf LLC v. Cumbess (In re Cumbess)*, 19-12088 (11th Cir. June 3, 2020).

Eleventh Circuit joins the majority of circuits by holding that unforeseen, changed circumstances are not required to modify a chapter 13 plan.

Fourth Circuit Stands Alone in Limiting Chapter 13 Plan Modifications

Taking sides with the majority on a circuit split, the Eleventh Circuit upheld the bankruptcy court by ruling that an unanticipated change in circumstances is not required to justify the modification of a confirmed chapter 13 plan.

In the August 25 opinion, the appeals court found no "reason to add gloss to the statute Congress wrote" by imposing a condition to plan modification not contained in Section 1329.

Parting company with the Fourth Circuit, the Eleventh Circuit took sides with the First, Fifth and Seventh Circuits in holding that *res judicata* does not preclude modification of a confirmed chapter 13 plan.

Plan Modification to Lower Payments to Unsecured Creditors

The debtor owned a home with two mortgages. The chapter 13 plan was based on an assumption that the second mortgage was unperfected, thus creating a net of about $20,000 for distribution to unsecured creditors if the case were a chapter 7 liquidation.

To comply with the best interests test, the plan called for paying $450 a month for 60 months, to give unsecured creditors more than $20,000 and cover counsel's basic fee of about $4,500.

However, counsel for the debtor did not file a fee application before confirmation to cover the additional $8,000 spent in voiding the second mortgage for lack of perfection.

After confirmation, the debtor's counsel filed a motion to modify the plan along with a fee application for the $8,000 in post-petition fees. To pay the extra $8,000, the plan modification lowered the unsecured creditors' distribution to $12,000.

The chapter 13 trustee objected to confirmation, contending that the confirmed plan was *res judicata* and that the additional counsel fees were not unanticipated.

Bankruptcy Judge James R. Sacca of Atlanta overruled the objection and confirmed the amended plan. *In re Guillen*, 570 B.R. 439 (Bankr. N.D. Ga. April 10, 2017). Click here to read ABI's report on Judge Sacca's opinion.

Given the circuit split on a pure issue of law, Judge Sacca *sua sponte* certified a direct appeal to the circuit court. The Eleventh Circuit accepted the appeal.

The *Res Judicata* Exception for Plans

Writing for the court of appeals, Circuit Judge Stanley Marcus began by saying that confirmed chapter 13 plans are treated like final judgments under Section 1327. However, he said that Section 1329 "carves out a limited exception to this general rule" by allowing plan modifications "so long as they satisfy certain statutory requirements."

Section 1329 specifies four permissible modifications to a plan. Applicable to the case on appeal, subsection (a)(1) permits modification to "increase or reduce the amount of payments on claims of a particular class. . . ."

Judge Marcus said that the chapter 13 trustee wanted the court "to read one additional requirement into Section 1329 — that debtors show some change in circumstances before modifying confirmed plans."

Judge Marcus declined "to graft this requirement onto the statute." He said the court could end its analysis with the "plain text" of Section 1329.

However, Judge Marcus went on to buttress his conclusion "by reference to the broader statutory scheme." He listed several instances in the Bankruptcy Code where the statute requires the court to consider "circumstances."

'Circumstances' Not in Section 1329

Using the term elsewhere shows that Congress knew how to require consideration of "circumstances," but the concept is not contained in Section 1329. He alluded to the chapter 11 counterpart in Section 1127(b), where a plan may be modified "only if circumstances warrant such modification."

For individuals in chapter 11, however, the "circumstances" condition is omitted in Section 1127(e). Judge Marcus observed that Section 1127(e) is "virtually identical to Section 1329(a)."

Judge Marcus answered the Fourth Circuit's argument that courts would be swamped with modifications if there were no requirement for unanticipated, changed circumstances.

Being "unpersuaded," Judge Marcus said that "general policy concerns cannot overcome the plain language of the statute." In addition, "Congress built ample safeguards into Section 1329 that stand in the way of frivolous modifications."

Judge Marcus had one final hurdle to overcome: *dicta* in a prior Eleventh Circuit opinion.

In *In re Hoggle*, 12 F.3d 1008, 1011 (11th Cir. 1994), the Eleventh Circuit said that "Congress designed § 1329 to permit modification of a plan due to changed circumstances of the debtor unforeseen at the time of confirmation."

Hoggle was construing a different provision, Section 1322(b)(5). In addition to the fact that the statement was *dicta*, Judge Marcus said that an "unforeseen change in circumstances is a good reason to permit a modification that otherwise satisfies § 1329. But that is not to say it is the only reason."

Judge Marcus affirmed Bankruptcy Judge Sacca, holding that "a debtor need not make any threshold showing of a change in circumstances before proposing a modification to a confirmed plan under § 1329."

The opinion is *Whaley v. Guillen (In re Guillen)*, 17-13899, 2020 BL 322688 (11th Cir. Aug. 25, 2020).

Sixth Circuit is the first court of appeals to take sides on a lower court split and opine that continuing to make voluntary contributions to retirement plans is excluded from 'disposable income.'

Sixth Circuit Allows Chapter 13 Debtors to Continue Retirement Plan Contributions

The Sixth Circuit became the first appeals court to rule on whether a chapter 13 debtor may deduct contributions to a 401(k) plan from "disposable income" and thereby reduce payments to unsecured creditors under a chapter 13 plan.

In a split decision on June 1, the Sixth Circuit held that a debtor who was making contributions to a 401(k) before bankruptcy may continue making contributions in the same amount by deducting the contributions from "disposable income." The majority saw the 2005 amendments as changing the law, while the dissenter interpreted the amendments as codifying the prevailing decisions handed down before the change in Section 541(b)(7).

Although the majority opinion is pro-debtor and the dissenter could be seen as pro-creditor, both opinions were written by judges appointed by President Trump. Also, they took fundamentally different approaches to the interpretation of a poorly written statute.

The Debtor's Plan

Long before bankruptcy, the debtor had been making monthly, voluntary contributions of $220 to her 401(k) plan. She proposed a chapter 13 plan calling for her to make monthly payments of $323. Were the plan confirmed, unsecured creditors with claims of about $190,000 would receive a recovery of some 10%.

To confirm the plan, the debtor was required to devote all of her "projected disposable income" to unsecured creditors under Section 1325(b)(1). The chapter 13 trustee objected to confirmation because the debtor was deducting 401(k) contributions from her calculation of "disposable income."

The bankruptcy judge upheld the objection, feeling bound by *dicta* in *Seafort v. Burden* (*In re Seafort*), 669 F.3d 662 (6th Cir. 2012).

In *Seafort*, the Sixth Circuit held that a debtor could continue deducting repayments of a loan from a 401(k) account from disposable income until the loan was repaid. Once repaid, the appeals

court did not permit further deductions from disposable income for what would become new contributions to the retirement fund.

However, the Sixth Circuit went on to say in *dicta* in a footnote that a debtor may never deduct contributions to a retirement account, even if the debtor had been making contributions before bankruptcy. *Id*., 669 F.3d at 674 n.7. The footnote ended by saying, "However, our view is not relevant here, because this issue is not presently before us."

The debtor amended her plan to include the 401(k) contributions in disposable income. The bankruptcy court confirmed the plan, but the debtor appealed. The bankruptcy court authorized a direct appeal to the circuit, which the appeals court accepted.

On appeal, the debtor was represented *pro bono* by former Chicago Bankruptcy Judge Eugene R. Wedoff, a recent past president of the American Bankruptcy Institute. He told ABI, "I think the decision is very thoroughly and carefully considered, and I think it will be helpful to any court that is faced with the issue in the future."

The Perplexing Statute

The appeal turned on Section 541(b)(7), one of the most poorly drafted provisions added in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act, known as BAPCPA.

Section 541(b)(7)(A) 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 have been 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.

The Majority Opinion

In the majority opinion, Circuit Judge Joan Larsen reported how courts overwhelmingly held before BAPCPA that retirement plan contributions were included in disposable income. After BAPCPA, she said that "most" courts believe that contributions are not part of disposable income.

However, Judge Larsen said that *Seafort*, handed down after BAPCPA, "squarely" rejected the holding by some courts that contributions are never included in disposable income, whether or not the debtor was making contributions before bankruptcy.

Judge Larsen devoted the remainder of her opinion to deciding whether she should follow the *dicta* in *Seafort*. To that end, she carefully laid out the four interpretations of the statute after BAPCPA and asked whether "such amount" in the hanging paragraph includes continued contributions to retirement accounts.

There are two prevalent interpretations of the hanging paragraph, "either of which will do some violence to the text," Judge Larsen said. She quoted Prof. David Gray Carlson as asking which is "the lesser of evils."

To resolve the question, Judge Larsen invoked three canons of construction to rule in favor of the debtor. First, she said that the reenactment canon indicates that Congress intended to alter existing law, where courts were not allowing debtors to deduct contributions from disposable income.

Next, Judge Larsen said that the presumption against ineffectiveness advises against an interpretation where the hanging paragraph would not change law. Third, she said that the canon against surplusage favors a construction where the hanging paragraph and Section 1325(b)(2) have "independent effect."

Applying the canons, Judge Larsen held that "the hanging paragraph is best read to exclude from disposable income the monthly 401(k)-contribution amount that [the debtor's] employer withheld from her wages prior to her bankruptcy." That way, she said, the amendment "actually amends the statute" and "also gives meaningful effect . . . to Congress's instruction in § 541(b)(7) that 401(k) contributions 'shall not constitute disposable income.'"

Among other authorities, Judge Larsen quoted the *Collier* treatise for saying that the hanging paragraph amendment "removes any doubt" that withholdings by employers are excluded from disposable income.

Although declining to follow *Seafort's dicta*, Judge Larsen did not disturb the holding that a debtor may not begin making contributions after paying off a loan from a retirement account.

Judge Larsen said her holding was "narrow" and "may necessitate a more searching good-faith analysis."

A district court in Louisiana last year upheld the bankruptcy court and allowed contributions up to the IRS limits. *See Miner v. Johns*, 589 B.R. 51 (W.D. La. May 23, 2018). To read ABI's report on *Miner*, click here.

The Dissent

Circuit Judge Chad A. Readler "respectfully" dissented. To him, *Seafort* "all but held" that a debtor cannot make contributions after bankruptcy, even if he or she was making them beforehand.

Judge Readler saw BAPCPA as drawing a "simple bright-line rule: a debtor's pre-filing 401(k) contributions are protected from creditors; those sought to be made during the post-filing Chapter 13 reorganization period are not."

Rather than changing law, Judge Readler interpreted BAPCPA as "codifying these predominant judicial interpretations" that require the inclusion of contributions in disposable income. He saw his reading of the statute as being in accord with the perceived policy in BAPCPA that a debtor must pay as much as possible toward the claims of unsecured creditors.

To that end, he saw the majority as creating "a massive loophole permitting a Chapter 13 debtor nonetheless to dramatically undermine creditors by dedicating her post-petition income to a 401(k), for her own future use."

The opinion is *Davis v. Helbling (In re Davis)*, 19-3117 (6th Cir. June 1, 2020).

When personal property loans are cross-collateralized, a chapter 13 plan must use the same option for cramming down both loans, the Fifth Circuit says.

Cross-Collateralization Turns Two Loans into One Claim in the Fifth Circuit

If a chapter 13 debtor has two secured claims that are collateralized with personal property, and if the loans are cross-collateralized, a chapter 13 plan may not surrender the collateral for one loan and cram down the other, according to the Fifth Circuit.

In other words, the Fifth Circuit believes that cross-collateralizing two personal property loans converts two claims into one claim, with the result that the debtor may employ only one of the options for dealing with secured claims under Section 1325(a)(5).

Apparently at different times, the debtor purchased two cars. He financed both with secured loans from the same lender. The security agreements cross-collateralized the loans.

The debtor filed a chapter 13 plan, cramming down on the lender. The plan called for surrendering one car and cramming down the loan on the other to the value of the car that the debtor was keeping. The bankruptcy court overruled the lender's objection and confirmed the plan. The district court reversed.

The outcome turned on the two options for dealing with (*i.e.*, cramming down) a secured creditor that does not accept the plan. Under Section 1325(a)(5)(B) and (C), the debtor may pay the allowed amount of the secured claim (that is, the value of the collateral) "or" surrender the collateral.

The debtor focused on the statutory language allowing the debtor to select an option "with respect to each allowed secured claim." The lender countered, contending that the use of "or" in Section 1325(a)(5) means that a debtor may use only one of the options.

The appeal was *sub judice* in the circuit for almost two years. In an opinion on January 14, Circuit Judge Priscilla R. Owen agreed with the lender.

Judge Owen relied heavily on Fifth Circuit precedent, *Williams v. Tower Loan of Mississippi* (*In re Williams*), 168 F.3d 845 (5th Cir. 1999). She characterized *Williams* as involving a chapter 13 debtor who "sought to address one secured claim by surrendering some of the collateral securing the claim and paying the cram down value of the remaining collateral."

In *Williams*, Judge Owen said the circuit "held that the debtor's plan could not be approved because '[t]he plain language of [§ 1325(a)(5)] does not give the debtor the right to adopt a combination of the options offered in (B) and (C).'" She characterized *Williams* as holding "that debtors must select the same § 1325(a)(5) option for all of the collateral securing a single claim."

The Second Circuit reached the same result in a chapter 12 case, Judge Owen said, citing *First Brandon National Bank v. Kerwin* (*In re Kerwin*), 996 F.2d 552 (2d Cir. 1993).

Applying the facts to the law, Judge Owen held that the plan "must select the same § 1325(a)(5) option for both items of collateral."

Judge Owen affirmed the district court and set aside confirmation, saying that the debtor's argument was "contrary to the plain language of § 1325(a)(5)."

Observation

Williams was not controlling. Influential, yes, but not on point and distinguishable. *Williams* dealt with one claim having several elements of collateral. The case before Judge Owen arguably dealt with two claims.

One may wish to question where the statute converts two secured notes into one claim, when each has different primary capital. Although there is one creditor who could file one proof of claim, aren't there two claims? Judge Owen seems to have expanded *Williams* substantially.

The loans did not entail purchase money security interests in their entirety. In other respects, the Bankruptcy Code gives fewer rights to holders of non-purchase money security interests.

Another court might find that the plain language of the statute supports the debtor, not the creditor.

The opinion is *Barragan-Flores v. Evolve Federal Credit Union (In re Barragan-Flores)*, 984 F.3d 471 (5th Cir. Jan. 14, 2021).

Court cannot impose a nonstatutory provision on a chapter 13 'full payment' plan that restricts the debtor's right to modify a confirmed plan.

Fifth Circuit Bans *Molina* Provisions in Chapter 13 Plans

When a chapter 13 debtor has excess disposable income not being paid to creditors every month, some courts in Texas have been imposing a so-called *Molina* provision on the plan that bars the debtor from receiving a discharge if unsecured creditors are not paid in full.

The Fifth Circuit held on June 8 that including so-called *Molina* language in a plan violates the debtor's right to modify the plan under Section 1329.

The debtor had less than $7,800 in unsecured claims. He proposed a five-year plan to pay his secured and unsecured creditors in full with payments of about $1,000 a month through the chapter 13 trustee.

After the monthly payments, the debtor had excess disposable income of about $1,100 a month. The trustee therefore urged the court to deny confirmation unless the debtor acceded to including *Molina* language in the plan.

In substance, a *Molina* provision provides that a debtor may not modify his or her plan unless unsecured creditors are paid 100%. It further provides that the debtor will not receive a discharge unless unsecured creditors are paid in full.

The debtor reluctantly included a *Molina* provision in the plan, but he appealed confirmation. The district court certified the case for a direct appeal to the Fifth Circuit. The appeals court accepted the appeal.

Circuit Judge Leslie H. Southwick vacated the confirmation order. He explained that the *Molina* provision derives its name from a district court opinion in the Western District of Texas: *Molina v. Langehennig*, 14-926, 2015 WL 8494012, at *1 (W.D. Tex. Dec. 10, 2015). The district court had upheld confirmation of a 100% plan that included language preventing the debtor from receiving a discharge unless unsecured creditors were paid in full, because the debtor had excess monthly disposable income. To read ABI's report on *Molina*, click here.

The appeal turned chiefly on Sections 1325(a), 1325(b)(1), and 1329. Section 1325(a) provides that the court "shall" confirm the plan if it complies with chapter 13 and with applicable provisions in the Bankruptcy Code.

Of particular significance, Section 1325(b)(1) provides that the court may not confirm a plan unless it (1) pays unsecured claims in full, ***or*** (2) devotes all of the debtor's projected disposable income to the payment of unsecured claims.

Even though he was not paying all of his disposable income to the trustee each month, the debtor argued that he was entitled to confirmation because he satisfied Section 1325(b)(1)(A) by promising to pay unsecured creditors in full.

Judge Southwick agreed. Because Section 1325(b)(1) uses the disjunctive "or," the debtor was not required in addition to comply with 1325(b)(1)(B) by paying all of his disposable income to creditors every month. In other words, the debtor was entitled to stretch out payments, so long as unsecured creditors are ultimately paid in full.

The trustee contended that the *Molina* provision was designed to prevent creditors from bearing the risk that the debtor will retain some of his disposable income but default on the plan and not pay everyone in full.

Judge Southwick responded by saying that the court could not impose the *Molina* provision by exercising equitable powers under Section 105(a), because equity cannot override explicit provisions of the Bankruptcy Code, citing *Law v. Siegel*, 571 U.S. 415, 421 (2014). He buttressed his conclusion by saying that a chapter 13 trustee has no statutory power to control the debtor's use of excess disposable income.

Significantly, Judge Southwick rejected the trustee's contention that a debtor's retention of excess disposable income "is inherently bad faith and manipulation of the Code." He also rejected the trustee's argument that Section 1325(b)(1)(A) specifies the minimum that a debtor must pay.

Judge Southwick rested his conclusion on the plain language of the statute and Section 1325(b)(1)'s use of "or." In other words, "a debtor does not need to comply with both subsection[s] (b)(1)(A) and (b)(1)(B)."

Although he was tempted to do so, Judge Southwick did not rest the decision on Section 1325(b)(1). Instead, he decided that the "*Molina* language violates Section 1329." That provision entitles a debtor to amend a plan after confirmation, so long as the amended plan complies with confirmation standards.

However, Judge Southwick added a caveat. If "a debtor in bad faith requests a modification of the plan, it is within the bankruptcy court's discretion to deny that request," he said.

Judge Southwick vacated the confirmation order and remanded the case for the court to make findings of fact required for confirmation, such as good faith.

The opinion is *Brown v. Viegelahn (In re Brown)*, 19-50177 (5th Cir. June 8, 2020).

Lease assumption is binding even if the debtor doesn't follow the procedural requirements of Section 365(p).

Ninth Circuit Says Assumption Under Section 365(p) Doesn't Also Require Reaffirmation

The first court of appeals to address the question, the Ninth Circuit held that an individual can assume a personal property lease under Section 365(p) without reaffirming the debt with court approval under Section 524(c).

Perhaps more controversially, the Ninth Circuit also held that a lease assumption is binding on the debtor even if the debtor has not complied with the procedural steps required by Section 365(p).

In his August 3 opinion, Circuit Judge Eric D. Miller observed that the bankruptcy courts are divided on whether an assumption under Section 365(p) also requires reaffirmation under Section 524(c). No circuit court has confronted the issue, he said.

The Leased Car

The chapter 7 debtor originally intended to keep her leased car and stated her intention to reaffirm the debt. She called the lessor and asked about keeping the car. The lessor told her that she must assume the lease and sent her an assumption agreement. The debtor did not sign and return the assumption agreement until the day before receiving her discharge, about three months after asking the lessor for assumption.

A month before returning the signed assumption agreement, the debtor stopped paying on the lease. She later surrendered the car to the lessor but refused to pay what she owed on the lease.

The debtor filed a motion in bankruptcy court seeking fees and more than $50,000 in sanctions for violating the discharge injunction. The debtor contended that the lease-assumption agreement was not enforceable because she had not reaffirmed the debt under Section 524(c).

Affirmed in district court, Bankruptcy Judge Laura S. Taylor denied the motion for sanctions, ruled that the debtor had assumed the lease and said no reaffirmation was required.

BAPCPA Added Section 365(p)

Until 2005, only a chapter 7 trustee could assume a personal property lease. That year, the so-called BAPCPA amendments added Section 365(p), which allows a debtor to assume a lease of personal property.

The subsection does not require court approval, but it obliges the debtor to request assumption in writing from the lessor. The lessor may agree to assumption or demand cure. If the lessor agrees to assumption, the debtor has 30 days to notify the lessor that the lease is assumed. Assumption becomes a liability of the debtor, not of the estate.

Judge Miller said that the debtor did not follow Section 365(p) in two ways: She did not make her assumption request in writing, and she did not respond to the lessor within 30 days of receiving the assumption agreement.

Still, Judge Miller said that the debtor's "failure to follow section 365(p)'s requirements cannot excuse her from the lease assumption to which she agreed." He cited the Supreme Court for the idea that people may waive statutory provisions if there is no public interest.

Because the debtor's assumption did not affect any creditor's recovery, Judge Miller found nothing in the Bankruptcy Code or caselaw to prohibit waiver. Thus, he agreed with the bankruptcy court and held that the lease was assumed.

Conflict with Section 524(c)

But what about Section 524(c), which lays down strict requirements for reaffirmation? Must a debtor go through reaffirmation under Section 524(c) on top of assumption under Section 365(p)?

Judge Miller found "an apparent conflict between Sections 365(p) and 524(c)."

Section 524(c) has several provisions that would not have been satisfied if reaffirmation were also required. Among other things, reaffirmation requires court approval and proof that the debtor knows what she's getting into.

If reaffirmation were also required, as the debtor contended, she had no liability on the lease even though she had signed the reaffirmation agreement. Judge Miller found conflicting authority among the bankruptcy courts and no ruling at the circuit level.

If assumption also required reaffirmation, Judge Miller found ways in which some of the statutory language would be superfluous. For instance, the more debtor-friendly assumption provisions would be displaced by the more onerous requirements of Section 524(c).

"If the Code requires a separate reaffirmation agreement in order to make a lease assumption effective," Judge Miller said, "it is difficult to see how Section 365(p)(2) serves any purpose." He

also said that the more specific provisions in Section 365(p) govern over the more general ones in Section 524(c).

Judge Miller found "no absurdity in allowing a debtor to assume a car lease without judicial approval when she can also reaffirm a home mortgage without judicial approval" under Section 524(c)(6)(B). He noted the title of the BAPCPA amendment, "Giving Debtors the Ability to Keep Leased Personal Property by Assumption." He said it "indicates that the purpose of adding Section 365(p) was to give debtors a way to continue using their leased vehicles — the most common type of leased personal property — during and after bankruptcy without engaging in the more onerous requirements of section 524(c)."

Judge Miller held that assumption does not also require reaffirmation because imposing the demands of Section 524(c) "would frustrate that purpose by eliminating the debtor-friendly option that Congress provided."

The opinion is *Bobka v. Toyota Motor Credit Corp.*, 18-55688 (9th Cir. Aug. 3, 2020).

Deferred payments to unsecured creditors in a chapter 13 plan must equal the present value of the distributions required by the best interests test, Judge Halfenger says.

Courts Split on Whether Counsel Fees Are Considered in Chapter 13 Best Interests Test

On a question where the lower courts are split, Chief Bankruptcy Judge G. Michael Halfenger of Milwaukee decided that the fees paid for a chapter 13 debtor's counsel must be taken into consideration in calculating whether the plan satisfies the best interests test.

The debtor filed a 36-month chapter 13 plan calling for payments to unsecured creditors totaling about $4,000. The debtor's counsel fees of some $4,500 were presumed to be reasonable and would be an automatically allowed administrative expense under the local rules.

Were the debtor's assets to be liquidated in chapter 7, the chapter 13 trustee calculated that the unsecured creditors would receive $8,500 in distributions after paying some $1,700 for the chapter 7 trustee's commissions.

The chapter 13 trustee objected to confirmation of the chapter 13 plan, contending that unsecured creditors must be paid $8,500 to satisfy the so-called best interests test under Section 1325(a)(4). In other words, the trustee believed that the debtor's attorneys' fees should not be taken into consideration in calculating the best interests test.

In his February 16 opinion, Judge Halfenger acknowledged two bankruptcy court decisions that supported the trustee and disallowed deductions for the debtor's counsel's fees in the best interests calculation.

Judge Halfenger said the trustee's position had "some intuitive appeal" and was based on a policy that unsecured creditors should not be paying the attorneys' fees that would be avoided if the debtor filed directly into chapter 7.

However, Judge Halfenger said that the policy, "no matter how strong," cannot "overcome either the statute's plain text or the Supreme Court's construction of the same phrase." He therefore disagreed with the trustee and found the answer in the language of the governing statutes and rules.

Section 1325(a)(4) calls for employing the best interests test as of "the effective date of the plan," a term not defined in the Bankruptcy Code. The word "effective" means the "operative" date of the plan, Judge Halfenger said.

Judge Halfenger concluded that a "plan is operative when its terms are binding on the debtor and creditors — *i.e.*, when the court confirms it." He cited two Supreme Court opinions reaching the same conclusion in different contexts under chapter 13.

What about the debtor's counsel's fees? What would their status be on confirmation?

The fees fell under the so-called no-look local rule and would be automatically allowed as administrative expenses on confirmation, because no one objected.

If the case converted to chapter 7 before confirmation, the debtor's counsel's fees would be allowed chapter 13 administrative expenses that the chapter 7 trustee would be obliged to pay in full before making distributions to unsecured creditors under Sections 507(a)(2) and 726(a)(1).

Judge Halfenger therefore deduced that the debtor's counsel's fees are included in the determination of best interests. There was a glitch, however.

The plan called for paying counsel fees before the chapter 13 trustee commences paying unsecured claims. The result would be a delay of at least one year before the first payments to unsecured creditors.

The best interests test in Section 1325(a)(4) requires giving unsecured creditors "the value" they would receive "as of the effective date of the plan." Citing Supreme Court authority, Judge Halfenger said that value as of the effective date means that the present value of the deferred payments must equal $4,000.

Judge Halfenger in substance directed the debtor to amend the plan to give unsecured creditors the present value of $4,000 in future payments.

The opinion is *In re Buettner*, 20-42696, 2021 BL 54866, 2021 Bankr Lexis 363 (Bankr. E.D. Wis. Feb. 16, 2021).

Compensation

Long Island judge finds no ambiguity in two statutes that other courts have found ambiguous when read together.

Courts Split on Paying Chapter 13 Trustee Fees in Cases Dismissed Before Confirmation

Taking sides on an issue where the courts are divided, Bankruptcy Judge Robert E. Grossman of Central Islip, N.Y., decided that a chapter 13 trustee is entitled to retain his or her statutory fee even if the case is dismissed before plan confirmation.

The debtor appealed the same day the decision came down.

Judge Grossman found the result in the plain language of the statute but carefully parsed decisions coming out the other way, including a contrary opinion in February by Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho. *In re Evans*, 19-40193, 2020 BL 53269, 2020 WL 739258 (Bankr. D. Idaho Feb. 13, 2020). To read ABI's report on *Evans*, click here.

The debtor in Judge Grossman's case filed a chapter 13 plan where he paid the trustee $362,000 in a lump sum. Soon after, the debtor decided to dismiss 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. Technically speaking, the debtor was not objecting to the trustee's final report. The debtor lost on every argument he raised.

Two statutes informed Judge Grossman on the outcome.

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)." The subsection says nothing explicitly about the trustee's fee.

As Judge Meier said in the *Evans* case, the two statutes "appear to conflict" and "are ambiguous" when "construed together." Unlike chapter 13, where the statute does not address the

issue directly, Judge Meier also pointed out how Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed.

Before addressing the two statutes, Judge Grossman first examined his power to provide a remedy. He ruled in his November 12 opinion that he lacked the equitable power to require disgorgement of part or all of the fee. Because the fee is fixed by statute, he said that "the Court has no authority to fix the dollar amount of the fee the Trustee receives in each Chapter 13 case."

Next, Judge Grossman said that the proper procedure called for objecting to the trustee's final report, as opposed to moving for disgorgement. He then examined the two statutes as though the debtor had objected to the final report.

Finding no ambiguity, Judge Grossman said that the "plain meaning" of Section 586(e) "reveals that the Trustee collects his percentage fee regardless of whether the plan is confirmed." He emphasized the statutory language which provides that the trustee "shall collect [his fee] from all payments received by [the trustee] under the plan. . . ."

Judge Grossman went on to say that the word "plan" is not limited to confirmed plans. He found no ambiguity in the word even taking Section 1326(a)(1) into consideration. He said that Section 1326(a)(1) requires returning payments to the debtor that are "not yet due and owing to creditors."

Judge Grossman interpreted the sections to mean that "the Debtor is only entitled to a return of the funds earmarked for creditors."

The policy underlying the system of standing chapter 13 trustees also influenced the decision by Judge Grossman. Congress designed the system to be self-funding.

"To permit debtors to evade payment of these fees solely on the basis of the success of their plans," Judge Grossman said, "would result in an outcome inconsistent with Congressional intent and would ultimately hinder the abilities of the Trustee Program to fund itself."

Judge Grossman held that "the Trustee's fee is a user fee, directed by statute, that must be universally paid by all chapter 13 debtors regardless of the outcome of each case."

The opinion is *In re Soussis*, 19-73686, 2020 BL 439963 (Bankr. E.D.N.Y. Nov. 12, 2020).

Trustees in chapter 12 fare better than chapter 13 trustees if a case is dismissed before confirmation.

No Fees for a Chapter 13 Trustee in a Case Dismissed Before Confirmation

On an issue where the courts are split, Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho, decided that a chapter 13 trustee is entitled to no fee if the case is dismissed before confirmation.

The debtor filed a chapter 13 petition and had paid about $10,000 to the chapter 13 trustee before he took a voluntary dismissal. The trustee repaid some $9,000 to the debtor and filed a final report proposing to retain about $1,000 as the trustee's fee under 28 U.S.C. § 586(e).

In his 24-page opinion on February 13, Judge Meier sustained the debtor's objection to the final report and directed the trustee to return the $1,000 fee to the debtor under Section 1326(a)(2).

As Judge Meier said, two statutes "appear in conflict" and "are ambiguous" when "construed together."

Section 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 out . . . , after deducting any unpaid claim allowed under section 503(b)." The subsection says nothing explicitly about the trustee's fee.

Judge Meier cited cases coming down on both sides of the question: Does a chapter 13 trustee retain statutory fees in a case dismissed before confirmation?

A policy argument would allow a trustee to retain the statutory fee because otherwise, debtors in confirmed cases would be compensating trustees for cases that are never confirmed.

Judge Meier pointed out the stark difference between chapter 12 and chapter 13 cases. For a chapter 12 trustee, Section 1226(a)(2) specifically allows the trustee to retain the statutory fee if a plan is not confirmed.

Pointing out the difference in the provisions for chapters 12 and 13, the *Collier* treatise says that the trustee's retention of the fee "is unique to chapter 12. When a chapter 13 plan is denied confirmation, [the chapter 13 trustee] is not authorized to deduct" the statutory fee.

Judge Meier sided with *Collier* and an opinion from the Tenth Circuit Bankruptcy Appellate Panel that said that allowing a chapter 13 trustee to retain the fee "could be punitive to the debtor" in "cases involving a long delay in confirming the plan."

Judge Meier said that Section 1326(b) "only allows the trustee to pay creditors after a plan is confirmed. If the trustee cannot pay creditors until a plan is confirmed pursuant to § 1326(a)(2), then § 1326(b) [allowing the trustee to pay the trustee's fee] is not operative until a plan is in effect."

Although policy might argue for paying a trustee if a case is dismissed, Judge Meier decided that he "must rely on the text of the statute . . . and not decide the matter based on conflicting policy arguments."

In ruling that a trustee is not entitled to a fee if the chapter 13 case is dismissed before confirmation, Judge Meier also analyzed legislative history and decisions coming down on both sides. In substance, his opinion parses virtually every argument that could be made for either outcome.

In addition, Judge Meier consulted the chapter 13 trustees' handbook promulgated by the U.S. Trustee Program. The handbook is noncommittal. It instructs chapter 13 trustees to follow whatever rule the courts have established in the district.

The opinion is *In re Evans*, 19-40193, 2020 BL 53269 (Bankr. D. Idaho Feb. 13, 2020).

Exemptions

By adopting a BAP opinion, the Ninth Circuit backed away from disallowing exemptions when a debtor disposes of exempt property after the filing date.

Ninth Circuit Joins the Fifth by Endorsing the 'Snapshot Rule' for Exemptions

By adopting an opinion by the Bankruptcy Appellate Panel "in full," the Ninth Circuit has limited its own precedents constricting a debtor's ability to exempt a homestead.

In *Wolfe v. Jacobson (In re Jacobson)*, 676 F.3d 1193 (9th Cir. 2012), and *England v. Golden (In re Golden)*, 789 F.2d 698 (9th Cir. 1986), the Ninth Circuit declared that the debtors were not entitled to exemptions because the debtors sold their homesteads before or after filing. Both cases have now been limited to their particular facts.

Prior Ninth Circuit Authorities

In *Golden*, the earlier of the two cases, the chapter 7 debtor sold her home *before* bankruptcy and claimed an exemption to cover the proceeds. However, the debtor did not reinvest the proceeds in another home within six months, as required by California law. The Ninth Circuit ruled that the failure to reinvest under state law resulted in the loss of the homestead exemption, even though she would have been entitled to exempt the proceeds on the filing date.

In *Jacobson*, the Ninth Circuit expanded on *Golden*. The chapter 7 debtor sold her home *after* filing but did not reinvest the proceeds within six months as required by California law. Interpreting *Golden*, the Ninth Circuit reversed the BAP and held that the debtor lost the exemption, even though she would have been entitled to the exemption on the filing date.

The Case on Appeal

The case on appeal involved a chapter 7 debtor who co-owned a home in Washington State with her parents. She said that her interest was worth $90,000 and claimed a $125,000 homestead exemption.

She resided in the home on the filing date but married a short time later and moved in with her new husband. The chapter 7 trustee objected to the exemption, contending that she lacked the intent to reside in the home on the filing date and lost the exemption under Washington law when she moved out.

The BAP Opinion

The bankruptcy court overruled the objection, and the BAP affirmed in an opinion on March 23 by Bankruptcy Judge William J. Lafferty of Oakland, Calif. Others on the panel were Bankruptcy Judges Julia W. Brand and Scott H. Gan.

The trustee appealed the BAP's opinion. The Ninth Circuit heard argument on February 5. In a *per curiam* but precedential opinion on March 5, the appeals court affirmed "for the reasons stated" by the BAP. The circuit court went further by adopting the BAP opinion "in full."

Note: In nonprecedential opinions, appellate courts frequently affirm "for the reasons stated below." However, taking the next step in a precedential opinion and adopting the lower court's opinion is rare. In this instance, adopting the BAP opinion is significant because it has the effect of limiting *Jacobson* and *Golden*.

Washington Law

The debtor elected Washington exemptions, which grant a homestead exemption to property where the owner resides or intends to reside and that is "actually intended or used" as a principal residence. If the owner is not residing in the home, the owner may have an exemption by recording a declaration of exemption.

However, Washington law presumes a homestead to be abandoned if, in the absence of a declaration, the owner abandons the home continuously for six months.

Washington liberally construes the exemption in favor of debtors.

The BAP's Reasoning

Judge Lafferty laid out what is commonly known as the snapshot rule. He cited Section 522(b)(3)(A) for the proposition that "exemptions are to be determined in accordance with the state law applicable on the date of filing," citing *Jacobson*.

Although the debtor moved out shortly after filing, Judge Lafferty said:

> [T]he plain language of Washington's homestead statute reflects that Debtor was entitled to an automatic homestead exemption *on the petition date*, so long as she was occupying the Property as her principal residence, regardless of her future plans . . . . In other words, *if the owner is occupying the homestead property as of the petition date, the inquiry ordinarily ends there*; intent comes into play only if the owner does not occupy the property. [Emphasis added.]

The trustee countered by arguing that the exemption was conditioned on the debtor's remaining in the property or filing a declaration of nonabandonment. Naturally, the trustee relied on *Jacobson* and *Golden*, where the debtors' actions before or after filing resulted in loss of the exemption for failure to abide by state law.

Judge Lafferty conceded that the two cases "support the trustee's position," but he said in a footnote that "*Jacobson* appears to be an outlier in holding that post-petition events may impact a debtor's right to an exemption. In any event, that case is both factually and legally distinguishable from the matter presented here."

Rather than expand circuit precedent, Judge Lafferty instead focused on Washington law and "decline[d] to read the statute so broadly, particularly in light of the principle that Washington exemption statutes are to be interpreted liberally in favor of protecting family homes."

Judge Lafferty went on to say that the cases cited by the trustee, including the two Ninth Circuit precedents, were "all distinguishable" on their facts. The debtor resided in the home on the petition date, and that "was sufficient to confer automatic protection of the homestead," he said.

Moving out of the home was "simply irrelevant," Judge Lafferty said. He saw "no policy that would be served by denying Debtor her exemption under these facts." Indeed, he indicated that policy bent in favor of the debtor. He said that "a debtor's right to a homestead exemption in a chapter 7 case should not be predicated on the happenstance of how long the case remains pending."

Judge Lafferty (and therefore the Ninth Circuit) affirmed and remanded the case for the bankruptcy court to determine the amount of the exemption.

Observations

The opinion by Judge Lafferty is a ringing endorsement of the snapshot principle, where exemptions are determined as of the filing date and subsequent events do not matter, even if they would matter under state law.

Jacobson is indeed an "outlier," as Judge Lafferty said. The Fifth Circuit has moved away from results like *Jacobson*.

In In re Frost, 744 F.3d 384 (5th Cir. 2014), a couple owned a home when they filed a chapter 13 petition. Later, they sold the home but did not reinvest the proceeds in another exempt homestead. Without saying in the opinion whether the case was in chapter 7 or 13, the Fifth Circuit held in *Frost* that the proceeds lost their exempt status, relying in part on *In re Zibman*, 268 F.3d 298 (5th Cir. 2001). In *Zibman*, the debtors sold their home before filing but did not reinvest within the time required by state law.

In *Hawk v. Engelhart (In re Hawk)*, 871 F.3d 287 (5th Cir. Sept. 5, 2017), the Fifth Circuit backed away from *Frost* and *Zibman* by holding that property in an exempt individual retirement account on the filing date did not lose its exempt status if it was converted to nonexempt property after the filing of a chapter 7 petition.

Six months later, the Fifth Circuit expanded *Hawk* to cover homesteads, thus allowing a chapter 7 debtor to sell a home after filing but not lose the exemption, even if the proceeds were not reinvested in another house. *Lowe v. DeBerry (In re DeBerry)*, 884 F.3d 526 (5th Cir. March 7, 2018).

In other words, *DeBerry* and *Jacobson* are irreconcilable. They reach opposite results on the same facts. Indeed, *DeBerry* is squarely on point for the appeal in the Ninth Circuit and leads to the same holding and conclusion as the opinion by Judge Lafferty.

To read ABI's reports on *Hawk* and *DeBerry*, click here and here.

The opinion is *Klein v. Anderson (In re Anderson)*, 20-60014 (9th Cir. March 1, 2021).

On an issue where the courts are split, the Tenth Circuit BAP sides with debtors and allows them to retain postpetition appreciation in the value of assets that were in the estate on filing.

Chapter 13 Debtors Retain Appreciation in Property After Conversion or Plan Amendment

May a chapter 13 debtor retain the postpetition appreciation in the value of property?

In the context of amending a plan, Bankruptcy Judge Elizabeth E. Brown of Denver wrote the definitive opinion on September 29 allowing the debtor to retain all net proceeds from the sale of a homestead. Three days later, the Tenth Circuit Bankruptcy Appellate Panel upheld one of her earlier opinions allowing the chapter 13 debtor to retain appreciation in the home after conversion to chapter 7.

The BAP Decision on Conversion to '7'

In January, Judge Brown came down on the side of the debtors in a case involving the sale of the debtors' home before conversion to chapter 7. She was upheld in the BAP on October 2.

On filing their chapter 13 petition, a couple owned a home that was worth less than the combination of the mortgage and the $75,000 homestead exemption in Colorado. Two years after confirmation of their plan, the debtors sold their home for about $125,000 more than the agreed valuation on the filing date and soon converted the case to chapter 7.

The trustee filed a motion asking the debtors to turn over the net sale proceeds in excess of the homestead exemption. Judge Brown allowed the debtors to retain all of the proceeds and was affirmed in an opinion for the BAP by Bankruptcy Judge Terrence L. Michael.

The appeal turned on Section 348(f)(1), which underwent a 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 question on appeal, Judge Michael said, was whether "property of the estate" includes postpetition appreciation in value of property owned on the chapter 13 filing date.

Two years before the amendment, the Tenth Circuit had held that the prior formulation of the section meant that property acquired during the course of the chapter 13 case became part of the chapter 7 estate.

After amendment, Judge Michael said that Section 348(f)(1) "generally" means that "the estate in the converted case does not include property acquired after the original petition date." For support by implication, he cited *Harris v. Viegelahn*, 575 U.S. 510 (2015), where the Supreme Court ruled that wages earned after filing in chapter 13 do not ordinarily become estate property after conversion to chapter 7.

Noting how courts are split, the statute is ambiguous, Judge Michael said. Accordingly, he considered legislative history.

Judge Michael cited the House report on the amendment for saying that it was designed to overturn a Seventh Circuit decision allowing the chapter 7 estate to include property the debtors had inherited while in chapter 7.

More significantly, Judge Michael said that the legislative history "suggests" that Section 348(f) should not be interpreted to "disincentivize filing a chapter 13 case by penalizing debtors should the case convert to chapter 7." He therefore held that postpetition appreciation in the value of a debtor's prepetition property, including the increase in value of a home, "belongs to the debtor and does not become property of the estate upon conversion to chapter 7."

Plan Amendment After Appreciation

In her decision three days earlier, Judge Brown confronted a more complex case. When the debtor filed his chapter 13 petition, his home was worth less than the combination of the mortgage and his homestead exemption.

The debtor sold his home after confirmation at a price that generated net proceeds of some $11,000 more than the mortgage and exemption combined.

The trustee filed a motion to amend the plan to require the debtor to pay the $11,000 to creditors under the plan. The debtor at the same time filed a motion to amend the plan by allowing him to retain all the proceeds while cutting the lender out of the plan because the mortgage had been paid in full.

Modifying a plan after confirmation in view of the appreciation in the value of property is more complex because several provisions in chapter 13 are involved. The main questions center on Section 1329(b), dealing with plan modifications after confirmation, and Section 1325(a)(4), which requires meeting the best interests test "as of the effective date of the plan."

Does "effective date" mean the effective date of the original plan or the date when the plan was amended?

Like Judge Michael, Judge Brown focused on the "fundamental bargain of chapter 13 where a debtor trades his future income, not his property, to obtain a discharge." She sided with the *Collier* treatise in saying that the best interests test is not recalculated based on property values at the time of plan modification.

"Demanding an increase in plan payments because of a post-confirmation sale of property or its appreciation in value would threaten the very fabric of the chapter 13 bargain," Judge Brown said.

In allowing the debtor to retain all of the appreciation, Judge Brown analyzed a multitude of arguments and provisions in the Bankruptcy Code that might bear on the issue. Her opinion is a definitive analysis of the issue that should be cited whenever the question arises.

The opinions are *Rodriguez v. Barrera (In re Barrera)*, 20-003, 2020 BL 381720 (B.A.P. 10th Cir. Oct. 2, 2020); and *In re Baker*, 17-14041, 2020 BL 384756, 2020 Bankr Lexis 2771 (Bankr. D. Colo. Sept. 29, 2020).

Where the courts are split, Idaho judge sides with the Tenth Circuit BAP and allows a chapter 13 debtor to retain post-petition appreciation in the value of a homestead following conversion to chapter 7.

Court Lets the Debtor Keep Appreciation in a Home on Conversion from 13 to 7

On an issue where courts are split, Chief Bankruptcy Judge Joseph M. Meier of Boise, Idaho, followed the Tenth Circuit Bankruptcy Appellate Panel by holding that post-petition appreciation in the value of a homestead belongs to the debtor when a case converts from chapter 13 to chapter 7.

On filing her chapter 13 petition, the debtor valued her homestead at about $100,000. It was subject to a mortgage for about $62,000. At the time, the Idaho homestead exemption was $100,000.

The bankruptcy court entered an order limiting the debtor's exemption in the home to $32,000.

A few months after confirming her chapter 13 plan, the debtor converted the case to chapter 7. The chapter 7 trustee evidently believed that the home was worth more than $100,000. Surmising that the home was actually worth $140,000, the trustee wanted to sell the home out from under the debtor and limit her exemption in the proceeds to $32,000.

In his January 8 opinion, Judge Meier decided that post-petition appreciation in the home belongs to the debtor.

The debtor's first argument failed to persuade Judge Meier. She contended that the chapter 7 estate did not include her homestead because it vested in her on confirmation of the chapter 13 plan under Section 1327(b).

The outcome of the debtor's first argument turned on statutory language. When a chapter 13 case converts to chapter 7, Section 348(f)(1)(A) 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 [chapter 13] petition, that remains in the possession of or is under the control of the debtor on the date of conversion."

Judge Meier held that the plain language of the statute brought the home into the chapter 7 estate because the debtor owned the home on filing her chapter 13 petition.

The next question was this: Did the debtor's homestead exemption of $32,000 become immutably fixed on the chapter 13 filing date?

Again, the debtor lost, but the loss was not fatal.

"Under the 'snapshot rule,'" Judge Meier said, "the exemptions that can be claimed and the amount of such exemptions are frozen as of the date of the petition. [Citing Ninth Circuit authority.] The conversion of this case does not change the value of the Home or the exemption against it as they existed at the time of the petition."

Judge Meier thus held that the debtor's "homestead exemption remains limited to [$32,000] — the amount this Court previously determined Debtor could claim as an exemption based on the date of the petition."

The debtor was left with a final argument: Even though she was stuck with a $32,000 homestead exemption, was the debtor entitled to retain post-petition appreciation in the value of the home after conversion to chapter 7?

Here, courts are divided and the statute has no clear answer. Aside from caselaw in her favor, the debtor's best argument was based on the legislative history regarding Section 348(f)(1)(A), which Judge Meier quoted.

Judge Meier was persuaded by the analysis by Bankruptcy Judge Elizabeth E. Brown of Denver in *In re Barrera*, 620 B.R. 645 (Bankr. D. Colo. 2020). Judge Brown was affirmed by the Tenth Circuit Bankruptcy Appellate Panel in *Rodriguez v. Barrera (In re Barrera)*, 20-003, 2020 BL 381720, 2020 WL 5869458 (B.A.P. 10th Cir. Oct. 2, 2020) (appeal pending). To read ABI's report on the BAP's *Barrera* opinion, click here.

Judge Meier said that *Barrera* "better reflects the legislative intent of § 348."

"Based on the comments in the House Report," Judge Meier decided that "Congress took issue with the remedy Trustee seeks in this motion." He noted that the debtor "had equity in the Home on the date of the petition, [and] the home would likely have been abandoned to the Debtor if this case had proceeded under chapter 7 from its commencement."

Judge Meier held that "the appreciation should not belong to the estate now merely because the case began as a chapter 13 case and was converted to a chapter 7 case." He held that "the appreciation in the Home inured to the Debtor upon conversion."

The opinion is *In re Cofer*, 19-40361 (D. Idaho Jan. 8, 2021).

Circuit split is eroding on the loss of a homestead exemption for failing to reinvest proceeds from a sale after filing.

Asset Exempt in Chapter 13 Retains the Exemption After Conversion, First Circuit Says

On an issue where the circuits are divided, the First Circuit upheld the two lower courts by ruling that a 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.

The July 30 opinion from the Boston-based appeals courts is the latest evidence of an eroding circuit split. As it now stands, only the Ninth Circuit has authority starkly at odds with the decision by the First Circuit. The Fifth Circuit is backing off from *In re Frost*, 744 F.3d 384 (5th Cir. 2014), where the appeals court ruled that the exemption is lost if a home is sold after a chapter 13 filing and the proceeds are not reinvested.

As noted by the First Circuit, the contrary Ninth and Fifth Circuit opinions were both written before the Supreme Court made important pronouncements about the inviolability of exemptions and a debtor's property in *Harris v. Viegelahn*, 135 S. Ct. 1829 (2015), and *Law v. Siegel*, 571 U.S. 415 (2014).

The Facts

The debtor confirmed a chapter 13 plan under which he would retain his home and pay the mortgage directly. The home was in Maine, a state with a $47,500 homestead exemption. Maine opted out of federal exemptions.

One year after confirmation, the debtor decided to sell the home. The bankruptcy court approved the sale, which generated proceeds of almost $52,000 after paying the mortgage and closing costs. In accord with the bankruptcy court's order, the debtor retained $47,500, his homestead exemption. More than $4,000 went to the trustee for distribution to creditors.

Five months after closing, the debtor converted the case to chapter 7 and received his general discharge. When a homeowner sells a home, Maine law requires reinvesting the proceeds in another homestead within six months to maintain the exemption.

When the debtor did not purchase another home within six months, the chapter 7 trustee objected to the allowance of the debtor's homestead exemption in the proceeds. Chief Bankruptcy

Judge Peter G. Cary of Portland, Maine, overruled the objection. The district court affirmed last year, prompting the trustee to appeal again.

To read ABI's report on the district court opinion, click here.

The Code Governs

Circuit Judge O. Rogeriee Thompson began her analysis by citing the Supreme Court decisions from 1924 and 1943 establishing the so-called snapshot rule, where the debtor's financial condition is frozen on the filing date. The rule means that an "asset will retain whatever status . . . it had when the debtor filed for bankruptcy," she said.

Judge Thompson said, in substance, that an asset exempt on the filing date will retain its exemption unless there is a statutory exception permitting loss of the exemption.

Judge Thompson then inquired as to whether an exemption could be lost if a chapter 13 case was converted to chapter 7. Naturally, she cited Section 348(a) for the proposition that conversion from one chapter to another does not change the original filing date. In other words, "the estate does not begin anew" on conversion, she said.

"So, without a doubt," Judge Thompson said, "we examine [the debtor's] claim of a homestead exemption on the date he filed for his chapter 13 bankruptcy."

Because there are no statutory exceptions regarding the homestead exemption, Judge Thompson upheld the lower courts. But what about Maine law, where the exemption is lost in six months absent purchasing another homestead?

Judge Thompson said that "Maine's six-month period for protecting the value of that homestead would not apply. From our perspective, that is what the Code requires."

Contrary Circuit Authority

The trustee wanted the First Circuit to follow contrary authority: *Frost* from the Fifth Circuit, and *In re Jacobson*, 676 F.3d 1193 (9th Cir. 2012), from the Ninth Circuit. Judge Thompson said "these cases are unpersuasive," in part because neither "addresses the Code's valued 'fresh start' principles articulated in *Harris*."

Judge Thompson noted how *Frost* and *Jacobson* were written before the Supreme Court decided *Harris* and *Law*. The high court authorities tell lower courts that a debtor's property or exemptions cannot be invaded absent statutory authority.

In this writer's view, *Frost* has been all but abandoned by the Fifth Circuit. The New Orleans-based court has rejected *Frost* in cases where the facts were different. This writer is also of the opinion that a three-judge panel in the Fifth Circuit could rule contrary to *Frost* because it was impliedly overruled by *Harris* and *Law*.

To read about how subsequent panels of the Fifth Circuit have undermined *Frost*, click here.

The opinion is *Hull v. Rockwell (In re Rockwell)*, 19-2074 (1st Cir. July 30, 2020).

Claims

Appeals courts won't allow bankruptcy to shield debtors from paying parking tickets and fines incurred in the course of a chapter 13 case.

Seventh Circuit Holds that Parking Tickets and Fines Are Chapter 13 'Admin' Expenses

The Seventh Circuit slammed the door on another theory used by bankrupt citizens of Chicago to avoid paying traffic tickets and parking fines incurred while in chapter 13.

In March, the Chicago-based appeals court ruled that bankruptcy courts may not, as a general practice, approve chapter 13 plans providing for debtors' cars to remain estate property after confirmation. In that regard, the standard plan in Chicago deviated from Section 1327(b), which "vests all property of the estate in the debtor" upon confirmation.

The distinction is important. If a car after confirmation is property of the estate, it remains protected by the automatic stay. If it becomes the debtor's property, there is no protection from the automatic stay.

When a plan retained a car in a debtor's estate, the city could not collect a parking fine without obtaining a modification of the automatic stay. In his March opinion, Circuit Judge Frank Easterbrook said, "Immunity from traffic laws for the duration of a chapter 13 plan does not seem to us an outcome plausibly attributed to the Bankruptcy Code." To read ABI's report on the March opinion, click here.

In the March appeal, the City of Chicago had also contended that traffic tickets and parking fines incurred in the course of a chapter 13 case should be afforded administrative priority. At the time, Judge Easterbrook believed it was unnecessary to rule on administrative priority. However, the parties pointed out in a petition for rehearing that the issue needed to be decided.

So, the appeals court granted panel rehearing and reversed the two lower courts on the additional question of administrative priority. In his new opinion on November 12, Judge Easterbrook held that tickets and fines incurred during a chapter 13 case must be accorded administrative priority under Section 503(b).

In the new opinion, Judge Easterbrook relied primarily on the rationale in his March opinion.

To qualify for administrative status, tickets and fines must represent "actual, necessary costs and expenses of preserving the estate." To interpret the statute, Judge Easterbrook found guidance in a receivership decision from the Supreme Court. *Reading Co. v. Brown*, 391 U.S.471 (1968).

Judge Easterbrook characterized *Reading* as holding that "torts committed during a bankruptcy must be treated the same as debts voluntarily incurred." He went on to say, "What is true of involuntary debts for torts is equally true of involuntary debts amassed while operating a car."

To fit within the confines of Section 503(b), Judge Easterbrook said that "maintaining an automobile is necessary for the success of a Chapter 13 bankruptcy." If a driver must pay for gasoline and insurance, then a debtor must also necessarily pay involuntary debts like fines and tickets.

Judge Easterbrook cited several decisions from other circuit courts holding that fines for civil offenses committed during bankruptcy "must be treated as administrative expenses."

Judge Easterbrook summed up the rationale near the end of his opinion. Given that operating a car is necessary for a debtor to commute to work to earn the money required to make plan payments, "then the costs of operating that necessary asset are themselves necessary." He therefore held that "vehicular fines incurred during the course of a Chapter 13 bankruptcy are administrative expenses that must be paid promptly and in full."

Observations

Ironically, the debtor's theory that persuaded the lower courts ended up being the engine of the debtor's destruction in the Seventh Circuit.

The debtor argued that the car deserved protection from the bankruptcy court because the car was necessary for commuting to work and generating income to cover plan payments. Judge Easterbrook took the car's necessity for income production as reason for holding that car expenses are chapter 13 "admin" costs.

As it now stands in the Seventh Circuit, the city can file a motion to dismiss the chapter 13 case if the debtor does not promptly pay a ticket or fine. On dismissal, the city can impound the car. In addition, the debtor will not receive a discharge for the debts the debtor was paying under the plan.

But what if a chapter 13 debtor cannot pay other post-confirmation expenses? Do all expenses after confirmation fall into the category of administrative expenses?

If everything is an administrative expense, post-confirmation creditors can use the threat of dismissal to coerce payment. If everything is not an administrative expense, where is the line between personal expenses and administrative expenses?

If a debtor commutes to work on public transit, will the failure to pay parking fines result in dismissal? Will bankruptcy courts in Chicago come to the conclusion that post-confirmation administrative expenses are limited to those directly related to income production?

Conceivably, bankruptcy courts may apply the Seventh Circuit's holding only to situations where the debtor has declared that a car is necessary for income production.

The opinion is *In re Steenes*, 942 F.3d 834 (7th Cir. Nov. 12, 2019).

Automatic Stay

Judge Klein's opinion reads like an amicus brief urging the Supreme Court to grant 'cert' and resolve a circuit split by taking sides with the majority on Section 362(c)(3)(A).

Judge Christopher Klein Takes Sides on a Circuit Spilt Coming to the Supreme Court

This summer, the Supreme Court will consider granting *certiorari* to resolve a circuit split under Section 362(c)(3)(A).

The question is this: If a petition by an individual under chapters 7, 11 or 13 has been dismissed within one year, does the stay terminate automatically 30 days after a new filing only as to property of the debtor or as to property of both the debtor and the estate? *See* Rose v. Select Portfolio Servicing Inc., 19-1035 (Sup. Ct.).

In the case before the Supreme Court, the Fifth Circuit took sides with the majority by holding that the stay only terminates automatically as to property of the debtor, but the stay remains in place as to property of the estate. *Rose v. Select Portfolio Servicing Inc.*, 945 F.3d 226 (5th Cir. Dec. 10, 2019) (*cert*. pending). To read ABI's report on *Rose*, click here.

Bankruptcy Judge Christopher M. Klein of Sacramento, Calif., wrote an opinion on May 11 agreeing with the result in the Fifth Circuit. His opinion reads like an *amicus* brief urging the Court to grant *certiorari* and uphold the Fifth Circuit.

Judge Klein's decision is the best analysis so far of the mistakes made by the minority, who see a total termination of the automatic stay 30 days after a repeat filing. He expertly explains why the result in the Fifth Circuit properly follows the plain meaning of Section 362(c)(3)(A) and comports with the principles and procedures underlying bankruptcy administration.

Although he sits in the Ninth Circuit, Judge Klein disagreed with a decision by the Ninth Circuit Bankruptcy Appellate Panel that held that the automatic stay terminates in 30 days as to both estate property and property of the debtor. *See Reswick v. Reswick (In re Reswick)*, 446 B.R. 362 (B.A.P. 9th Cir. 2011).

The Facts in Judge Klein's Case

The facts confronting Judge Klein underscore the pernicious results that would flow from ending the stay automatically as to both the debtor's and the estate's property. The *pro se* debtor's

first chapter 7 petition had been dismissed on January 31, 2020, for failure to file schedules. He filed again under chapter 7 on February 10, this time with schedules.

Having reason to believe that the debtor was concealing property, the chapter 7 trustee was worried that the automatic stay would terminate entirely within 30 days, allowing a few creditors to glom assets that rightly belong to all creditors.

So, the trustee filed a motion asking Judge Klein to rule, among other things, that the stay would not terminate as to estate property, whether it was disclosed or not. Judge Klein wrote a 29-page opinion explaining why Section 362(c)(3)(A) only terminates the stay as to the debtor's property, if there is any.

Clumsy Drafting of Section 362(c)(3)

Section 362(c)(3)(A) is one of the most curiously drafted provisions in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, or BAPCPA. It uses the phrase "with respect to" three times.

If an individual's case under chapters 7, 11 or 13 has been dismissed within one year, the subsection provides that the automatic stay in Section 362(a) terminates 30 days after the most recent filing "with respect to any action taken with respect to a debt or property securing such debt . . . *with respect to the debtor* . . . ." [Emphasis added.]

The Circuit Split and the 'Cert' Petition

In December 2018, the First Circuit adopted the position taken by the minority of lower courts by ruling that Section 362(c)(3)(A) terminates the automatic stay entirely, including property of the estate. *Smith v. State of Maine Bureau of Revenue Services (In re Smith)*, 910 F.3d 576 (1st Cir. Dec. 12, 2018). To read ABI's discussion of *Smith*, click here.

The circuit split arose when the Fifth Circuit took the contrary view in *Rose* by holding that the stay only ends automatically as to the debtor's property. Represented by an attorney who clerked for Justice Anthony M. Kennedy, the loser in the Fifth Circuit filed a *certiorari* petition in February, highlighting the circuit split and the recurring importance of the issue.

The response to the *certiorari* petition is due June 4, meaning that the Supreme Court might not act on the petition before the end of the term. If there is no answer this term, the Court might pass on the petition at the so-called long conference in late September and issue a grant or denial of *certiorari* in early October. Because the government is the largest creditor in many bankruptcies, the Court might ask for the views of the U.S. Solicitor General, thus delaying action on the *certiorari* petition until early 2021.

Judge Klein's Opinion

For anyone litigating an issue under Section 362(c)(3)(A), Judge Klein's opinion is "must" reading. He says that the majority, more than 50 cases, follow the Fifth Circuit, while the First Circuit is in the minority, allied with over 20 lower court decisions.

Judge Klein defined the question as whether the reference in Section 362(c)(3)(A) to termination "with respect to the debtor" should be "construed implicitly to extend to the 'estate' . . . even though neither 'estate' nor 'property of the estate' appears in Section 362(c)(3)." In succinct, technical terms, Judge Klein held that "Section 362(c)(3) does not modify or affect Section 362(c)(1)."

According to Judge Klein, the majority sees no ambiguity in Section 362(c)(3) and follows the plain meaning of the statute. He describes the minority as finding the statute ambiguous, allowing them to infer an extension beyond the language of the statute "consistent with the Congressional purpose of thwarting bad-faith manipulations of bankruptcy."

Judge Klein said that the minority's "tunnel vision manifests itself by way of disregard of how Section 362(c)(3) applies in chapter 7."

Judge Klein devotes the bulk of his opinion to explaining how the minority's rule would have the practical effect of precluding a chapter 7 trustee from protecting estate property from the clutches of one or a few creditors. For instance, the stay would terminate before the Section 341 meeting and possibly before the debtor even files schedules. In other words, the stay would terminate before the trustee could find out if there was estate property to protect.

Likewise, the stay would terminate as to estate property that the debtor did not disclose. Absent Section 362(c)(3), the stay would remain as to undisclosed property, even after discharge.

Furthermore, the trustee would face an insurmountable burden in obtaining an extension of the stay because Section 362(c)(3)(B) requires a showing that the new case was "filed in good faith as to the creditors to be stayed."

Among other things, Judge Klein points out how there is no good faith requirement imposed on a chapter 7 filing. And even if the debtor did not file in good faith, the debtor's bad intentions should not bar a trustee from recovering property for the benefit of all creditors.

Judge Klein dissects the history surrounding the adoption of Section 362(c)(3) as part of BAPCPA. He points out that Section 362(h), also adopted in BAPCPA, refers to property of the estate and property of the debtor, thus showing that the omission of property of the estate in Section 362(c)(3) was no mistake.

In other words, the minority's interpretation makes some sense when a debtor files repeatedly in chapter 13 but has pernicious results if the later filing is in chapter 7. Judge Klein argues that the result should be the same regardless of whether the filings were in chapter 13 or chapter 7.

Judge Klein said that the minority opinions "neither mention nor attempt to explain the asymmetry between Section 362(h) and Section 362(c)(3)." He went on to say that "none of the minority cases involve a chapter 7 trustee concerned about preserving stay protection for property of the estate."

Judge Klein said it would have been "extraordinary for Congress to have eviscerated this fundamental protection for property of the estate without so much as an explanatory comment" in the legislative history. Later, he added that "Congress would not have intended such dramatic consequences without unambiguous explanation."

Judge Klein's opinion is chock full of other quotable quotes. For instance, he says that the minority's "benign check on shifty chapter 13 debtors turns malignant" when the stay evaporates as to estate property that a chapter 7 trustee could otherwise liquidate for the benefit of all creditors. He speaks of the "absurdity of extending Section 362(c)(3) to property of the estate" and the minority's "zero analysis of how the chapter 7 trustee fits in."

The opinion is *In re Thu Thi Dao*, 20-20742 (Bankr. E.D. Cal. May 11, 2020).

Taggart left open the question of whether the 'no objectively reasonable basis' standard for discharge violations also applies to contempt of the automatic stay.

Ninth Circuit BAP Applies *Taggart* to Violations of the Automatic Stay

Last year, the Supreme Court ruled unanimously in *Taggart* that the bankruptcy court "may impose civil contempt sanctions when there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful under the discharge order." *Taggart v. Lorenzen*, 139 S. Ct. 1795 (June 3, 2019).

The Ninth Circuit Bankruptcy Appellate Panel answered a question left open by *Taggart*: Does the *Taggart* standard apply to violations of the automatic stay?

In a nonprecedential opinion, the BAP held that the *Taggart* standard applies when a chapter 7 trustee seeks contempt sanctions for violation of the automatic stay under Section 362(a). By extension, the decision means that *Taggart* also applies when a corporate chapter 11 debtor seeks contempt sanctions. To read ABI's report on *Taggart*, click here.

A Straightforward Stay Violation

The chapter 7 trustee discovered that the second and third mortgages on the debtors' home did not correctly describe the property. The trustee demanded that the subordinate mortgage holders consent to the avoidance and preservation of the liens for the benefit of the estate.

The debtors' lawyer responded on behalf of both the debtors and the holders of the subordinate mortgages. The lawyer informed the trustee that he had filed new mortgages with the debtors' consent correcting the property descriptions. Evidently, the lawyer advised the debtors that they should enable the filing of the corrected mortgages.

The trustee filed a motion to hold the debtors, the subordinate mortgagees and the lawyer in contempt. At the first hearing, the bankruptcy judge said there was a "clear-cut" automatic stay violation. Before the next hearing, the mortgagees and the debtors settled with the trustee by paying $6,000 of the trustee's attorneys' fees totaling about $10,000. They also reconveyed the mortgages.

The trustee proceeded with the contempt motion against the lawyer. The lawyer claimed there was reasonable doubt that his actions violated the automatic stay.

The bankruptcy judge found a knowing and intentional violation of the stay because the lawyer prepared the corrective mortgage and advised his client that they should sign the mortgages. The bankruptcy judge also found a willful violation of the stay because there was no fair ground of doubt about the stay violation.

The bankruptcy court imposed a $4,000 sanction on the lawyer, representing the remainder of the trustee's counsel's fees.

The lawyer appealed.

The BAP's Nonprecedential Affirmance

The BAP affirmed in a *per curiam*, nonprecedential opinion on March 16. The panel consisted of Bankruptcy Judges Gary A. Spraker, Laura S. Taylor and Robert J. Faris.

The trustee was the moving party, not the individual debtors. The distinction is significant because Section 362(k) allows the recovery of actual and punitive damages and attorneys' fees by "an individual injured by any willful violation of a stay" in Section 362. The trustee is not an individual and thus was relegated to seeking a contempt citation and sanctions under Section 105(a) and common law governing contempt.

Citing *Taggart*, the BAP said that the "Supreme Court recently clarified the legal standard governing contempt in the discharge context." The BAP interpreted *Taggart* to mean there can be no contempt if there was a "fair ground of doubt" or there was an "objectively reasonable basis" for believing that the action did not violate the stay.

In a footnote, the BAP assumed that *Taggart* applies to the automatic stay because neither party argued to the contrary. Citing *Zilog, Inc. v. Corning (In re Zilog, Inc.)*, 450 F.3d 996, 1008 n.12 (9th Cir. 2006), *partially overruled on other grounds by Taggart*, 139 S. Ct. at 1802, the BAP went on to say in the footnote that applying the same standard to the automatic stay "is consistent" with Ninth Circuit precedent.

Applying *Taggart* to the case at hand, the BAP found "nothing in [the lawyer's] authorities even suggesting" that a mortgage holder could file a corrected mortgage to gain priority over a *bona fide* purchaser under California law. The panel concluded that the lawyer's "theory did not constitute a reasonable ground for [the lawyer] to doubt the applicability of the automatic stay to his actions."

The BAP said that the lawyer's arguments were "a disingenuous and cynical attempt to evade the clear mandate of the automatic stay." With a defense "unsupported by any authority," the panel

upheld the finding of contempt because the lawyer had "no objectively reasonable basis" to believe his actions did not violate the stay.

The BAP also ruled that the bankruptcy court did not abuse its discretion in assessing $4,000 in attorneys' fees.

The Recovery of Attorneys' Fees on Appeal

The panel turned to the question of whether the attorney could be held liable for the trustee's attorneys' fees on appeal.

Because Section 362(k) was not available, the trustee could recover attorneys' fees under Ninth Circuit precedent only under the bankruptcy court's civil contempt power. The Ninth Circuit has held that the contempt power does not include the ability to award attorneys' fees in defending a contempt ruling.

The BAP ruled that the lawyer was nonetheless liable for the trustee's attorneys' fees and double costs for prosecuting a frivolous appeal under Bankruptcy Rule 8020(a).

The panel said that the lawyer "has not cited any pertinent authority to support his interpretations of the automatic stay and California law" and that his arguments "are wholly without merit."

The BAP directed counsel for the trustee to file a declaration showing the reasonable costs and fees in connection with the appeal. The lawyer will have an opportunity to respond.

Observations

Taggart, of course, did not say whether the discharge standard applies to violations of the automatic stay. Language in the unanimous opinion by Justice Stephen G. Breyer could be cited either way.

We sought comment from three law professors. Here is what they had to say:

Charles J. Tabb, Mildred Van Voorhis Jones Chair in Law Emeritus, Univ. of Illinois College of Law:

"There are two clues in the *Taggart* opinion that cut in opposite directions, and I think the ultimate outcome is a very close question.

"First, in favor of extending *Taggart* to contempt for stay violations is the core 'old soil' reasoning of *Taggart*. Outside of 362(k) cases, the Code is silent on the contempt standard for

violating the stay injunction. The Supreme Court's basic rationale, that in such statutory silence cases the proper approach is to import the 'traditional standards in equity practice,' thus could equally be extended to stay cases.

"Second, however, and cutting the other way, is the fact that the Court was not silent about stay cases. Instead, the Court took careful pains to distinguish [stay] cases . . . , saying that the 'stay aims to prevent damaging disruptions to the administration of a bankruptcy case in the short run, whereas a discharge is entered at the end of the case and seeks to bind creditors over a much longer period.'

"One could make a cogent argument that this passage supports the view that the threat posed by a stay violation is both more harmful to the successful operation and functioning of the bankruptcy case than a discharge violation and less of a burden on creditors, and thus contempt can and should more readily be imposed as a sanction for violations. If I were a bankruptcy judge, that is the path I would take."

Bruce A. Markell, Professor of Bankruptcy Law and Practice, Northwestern Univ. Pritzker School of Law:

"I think, unfortunately, the court got it right under *Taggart*, subject to a few quibbles.

"If you don't have a statute available such as § 362(k), you go back to the common law standard for contempt . . . and that's the clear and convincing standard. But there is a great difference here between the common contempt of a judge's order and the violation of a statute . . . .

"Applying the clear and convincing standard here would thus seem to be a bad fit, primarily because of the questionable role of intention. Clear and convincing evidence of a judge-crafted injunction directed initially at the contemnor is a vastly different animal than finding similar evidence of the violation of a Congressionally drafted one . . . .

"All of this makes me wonder if a violation of the stay is not necessarily redressed by contempt, but by implication of a federal cause of action based on the violation of a statute. That is, look to *Cort v. Ash*, 422 U.S. 66 (1975)."

John A. E. Pottow, John Philip Dawson Collegiate Professor of Law, Univ. of Michigan Law School:

"*Taggart* seems to imply the absence of any liability *ab initio*. Yet the absence of a corporate debtor remedy under [Section 362(k)] is surely premised upon a belief that the judge will take care of matters through contempt, which now *Taggart* precludes, substantially de-fanging the Code from one of its core protections."

A Final Note

One of the overarching concerns of the Supreme Court in *Taggart* focused on the vague description of the discharge injunction in Section 524 and the resulting lack of clarity. The automatic stay and its exceptions, by contrast, are laid out in great detail in Section 362. Will the greater clarity about the scope of the automatic stay and the shorter duration of the stay make *Taggart* inapplicable to Section 362?

The opinion is *Suh v. Anderson (In re Jeong)*, 19-1244, 2020 BL 102971 (B.A.P. 9th Cir. March 16, 2020).

Estate Property

Are there two tests for the existence of a claim, one test for claims against the debtor and another for claims by the debtor?

'Accrual Test' Survives to Say Whether the Debtor or the Estate Owns a Claim

The Third Circuit's long-vilified *Frenville* opinion is experiencing a rebirth in the Sixth Circuit, at least with regard to legal malpractice claims committed against the debtor. On January 26, the Cincinnati-based appeals court held that a malpractice claim belonged to the debtors, not to the chapter 7 estate, because the claim did not accrue under state law until the debtors lost their discharges.

The Malpractice Claim

A couple consulted with counsel about their financial problems. The lawyers recommended filing a chapter 7 petition.

In their schedules, the debtors listed $6,000 in assets. The trustee later determined that they had million in assets in a web of trusts and shell companies. Eventually, the debtors lost their discharges for failure to disclose assets.

The Sixth Circuit's opinion by Circuit Judge Bernice Bouie Donald did not say whether the debtors contributed to their own loss of discharge by failing to disclose assets to their attorneys. The opinion also does not state whether the lawyers knew about the potential nondisclosed assets and advised their clients not to schedule them, or even told them about the risk of nondisclosure.

The debtors filed a legal malpractice suit against their lawyers in state court after losing their discharges. Having received derivative standing, a creditor filed a malpractice suit in bankruptcy court. On cross motions for summary judgment, the bankruptcy court applied Tennessee law and granted summary judgment in favor of the debtors, holding that the malpractice claim belonged to them. The bankruptcy court reasoned that the malpractice claim accrued under state law after bankruptcy because damage did not occur until the debtors sustained injury when the court denied their discharges.

The Bankruptcy Appellate Panel affirmed in April 2019. *Church Joint Venture LP v. Blasingame (In re Blasingame)*, 597 B.R. 614 (B.A.P. 6th Cir. April 5, 2019). Because there was no pre-petition injury, the BAP ruled that "the malpractice cause of action arose post-petition and is not property of the bankruptcy estate." *Id.* at 619. To read ABI's report on the BAP opinion, click here.

Frenville

There is no longer a circuit split regarding the test to determine when a claim arose *against a bankruptcy estate* and was therefore discharged. As we shall see, there is less clarity in knowing whether a claim *against a third party* belongs to the estate or the debtor.

In *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.*), 744 F.2d 332 (3d Cir. 1984), the Third Circuit had held that a claim was not discharged in bankruptcy if it had not arisen *under state law* before bankruptcy. Third Circuit sat *en banc* in 2010, overruled *Frenville* and sided with seven other circuits. *See Jeld-Wen Inc. v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010).

In *Grossman's*, the Third Circuit held that an asbestos claim is presumptively discharged if exposure occurred before bankruptcy, even though injury was not manifest until years later. The *en banc* court reasoned that *Frenville* was contrary to the broad definition given to the word "claim" in the Bankruptcy Code.

As shown by the Sixth Circuit's new decision, the discredited *Frenville* concept still holds water in deciding whether a claim belongs to the estate or the debtor.

Is *Segal v. Rochelle* Still Good Law?

Typically, an analysis of estate property begins with a concept laid down by the Supreme Court under the former Bankruptcy Act. In *Segal v. Rochelle*, 382 U.S. 375 (1966), the Court ruled that an intangible claim is estate property if it is "sufficiently rooted in the prebankruptcy past." *Id*. at 380.

Judge Donald observed that the "sufficiently rooted" language "has a long and disputed history." She noted that the statutory definition of estate property changed with the adoption of the Bankruptcy Code in 1978.

Generally speaking, the Code attempted to broaden the concept of estate property. Judge Donald said that some circuits believe that the definition of estate property in Section 541 codified *Segal*, while others question whether the "rooted" concept survived the Code.

"There is little agreement" among the circuits, Judge Donald said, on how to apply *Segal* to a malpractice claim against a debtor's attorneys. Some apply the test "expansively," allowing the estate to capture contingent and unripe claims. Others rely on accrual under state law, thus allowing a debtor to retain a malpractice claim.

Although Sixth Circuit precedent did not answer the question on appeal, Judge Donald found guidance in *Tyler v. DH Capital Mgmt. Inc.*, 736 F.3d 455 (6th Cir. 2013). In *Tyler*, the occurrence of a pre-petition violation was one indicia of a claim belonging to the estate.

Judge Donald asked, "when did the violation occur?" Did the violation occur on the breach of duty or when damage was incurred? For the answer, she looked to Tennessee law.

Tennessee had changed its rule. Now, a malpractice claim accrues when a patient discovers or should have discovered injury.

Weaving *Segal* together with Tennessee law, Judge Donald said,

> [W]hile it remains difficult to determine whether, if ever, an unaccrued claim can be "sufficiently rooted" in a debtor's past, it is clear that at the very least there must be some awareness of the claim in order for it to exist as a legal interest and be properly included in the debtor's bankruptcy petition.

Judge Donald said that "Tennessee courts have likewise applied this same reasoning to their accrual rule, seeking to ameliorate the unjust results caused by treating a claim as accrued prior to a plaintiff's knowledge of the injury."

Applying the facts to the law, Judge Donald held that "the malpractice cause of action could not have become a legal interest under Tennessee law until after the judgment denying the [debtors'] discharge was entered because the [the debtors] were unaware of the filing attorneys' conduct, which allegedly constituted malpractice."

When the debtors filed their chapter 7 petition, "the malpractice claims were not a legal interest under Tennessee law such that they could be considered as property of the bankruptcy estate under federal law," Judge Donald said. She therefore affirmed the BAP and held that the malpractice claim belonged to the debtors.

Observations

Crucial facts are missing that could have affected the result.

Did the debtors tell counsel about their trusts and ownership interests? Did the debtors only tell counsel about the $6,000 in assets that ended up in the schedules, withholding information about other assets? Did counsel advise the debtors that their web of ownership interests need not be disclosed? Did counsel advise the debtors about the risk of nondisclosure? Did counsel know about the additional assets but omit them from the schedules at the direction of the debtors?

The trustee should have been able to discover answers to the foregoing questions because the trustee presumably controlled the debtors' attorney/client privilege.

If the debtors were responsible for nondisclosure, the lawyers may have a defense regardless of who owns the claim. Or, the lawyers may have a defense to a claim by the debtors but no defense to a claim by the trustee if the lawyers violated their obligations under Rule 9011. After all, nondisclosure caused the trustee and the surrogate to incur additional costs in discovering and recovering nondisclosed estate property.

If the debtors were responsible in part for nondisclosure, equitable principles might preclude them from owning the claim, assuming no bar under *Law v. Siegel*, 571 U.S. 415 (2014). It is also conceivable that a full revelation of the facts might show that the debtors and the trustee could assert different claims with different measures of damages.

Judge Donald's Dissent in *Underhill*

In her opinion, Judge Donald six times cited the nonprecedential Sixth Circuit opinion in *Underhill v. Huntington National Bank (In re Underhill)*, 579 F. App'x 480 (6th Cir. 2014). Judge Donald dissented in *Underhill*. She mostly cited her own dissent. The BAP decision relied heavily on *Underhill*.

In *Underhill*, a couple filed a chapter 7 petition, claiming that their closely-held corporation had no claims. The trustee reported "no assets."

As it turned out, the corporation had a tortious interference claim. The couple sued and received an $80,000 settlement. A creditor learned about the settlement and reopened the couple's bankruptcy. The bankruptcy court ruled that the settlement proceeds were estate property, and the BAP affirmed.

Interpreting *Segal*, the Sixth Circuit majority reversed the BAP. Judge Donald dissented, saying that the debtors were aware of the claim before filing but did not list any contingent or unliquidated claims. She said that the tortious interference claim was based in part on pre-petition conduct of which the debtors were aware.

Consequently, Judge Donald believed that the claim was "sufficiently rooted" in the pre-bankruptcy era to qualify as estate property.

Under Sixth Circuit precedent, Judge Donald said in *Underhill* that it was of "little significance" under Ohio law whether a tortious interference claim requires actionable damages. She said the majority "misplaced" reliance on the fact that the tortious interference claim was not actionable until after bankruptcy.

Had the facts been fully developed, Judge Donald might have been able to resuscitate her *Underhill* dissent. If the debtors were aware of the failure to disclose assets, her *Underhill* dissent would suggest that she could have found the malpractice claim to be estate property.

Overview

Should "claim" have a different meaning, depending on whether the claim is by or against the estate? On one level, two definitions make sense.

With regard to claims against an estate, a broad definition of claim makes sense. Companies could not reorganize in chapter 11 if they were to be sued after bankruptcy based on claims that did not manifest until after discharge.

Even with an expansive definition of "claim," creditors are protected by the Due Process Clause if unmanifested claims are discharged. Why? Because, debtors must create trusts to satisfy claims that do not manifest until after bankruptcy.

In the case of claims by a debtor, a broad definition can be unfair. The issue arises with regard to medical malpractice claims that do not manifest until after bankruptcy. Should a trustee swoop down and snatch away a malpractice claim that did not manifest until years after bankruptcy? Should debtors lose the fruits of a claim when malpractice caused actual pain and suffering or necessitated subsequent surgeries?

Having one definition is appealing but doesn't account for laudable human sympathies. Is the bankruptcy court still essentially a court of equity or an institution that unthinkingly applies a vaguely written statute?

The opinion is *Church Joint Venture LP v. Blasingame (In re Blasingame)*, 986 F.3d 633 (6th Cir. Jan. 26, 2021).

A bankruptcy court cannot delegate power to a state court to decide whether a claim is estate property, the Tenth Circuit BAP holds.

Bankruptcy Court Alone May Decide Whether a Claim Is Estate Property, BAP Says

The bankruptcy court is the only court with subject matter jurisdiction to decide whether a claim is estate property, according to the Tenth Circuit Bankruptcy Appellate Panel. Consequently, the panel ruled that it was an abuse of discretion when the bankruptcy court allowed the state court to determine whether creditors had "standing" to sue third-party recipients of fraudulent transfers.

The debtor operated a Ponzi scheme that defrauded investors. He nonetheless received a chapter 7 discharge in 2004.

In his bankruptcy papers, the debtor disclosed $11,500 in assets and listed $5 million in claims. He scheduled the investors as creditors.

Alleging that the debtor had concealed assets, several investors filed a motion 14 years after discharge to reopen the bankruptcy case and appoint a trustee.

At the same time, and without authorization from the bankruptcy court, the investors filed suit in state court against the debtor, his wife, and several related entitles. The complaint sought to recover fraudulent transfers and undisclosed property.

The debtor responded by filing a motion in bankruptcy court to sanction the investors for violation of the discharge injunction under Section 524(a). At the hearing, the debtor and the investors agreed that the state court could decide whether the investors had standing to sue. The chapter 7 trustee did not participate in proceedings on the sanctions motion.

The bankruptcy court denied the motion for sanctions, saying that the standing issue could be decided in state court.

The debtor appealed and won a reversal and remand in a July 30 opinion for the BAP by Bankruptcy Judge Terrence L. Michael.

The case turned on the BAP's interpretation of 28 U.S.C. § 1334(e)(1), which gives the district court "exclusive jurisdiction . . . of all the property, wherever located, of the debtor as of the

commencement of such case, and of property of the estate." Property that was concealed remains property of the estate under Section 554(c) even after discharge.

In view of Section 1334, Judge Michael held that "jurisdiction to determine what is property of the estate lies exclusively in the bankruptcy court." In turn, he said that the investors' standing "to pursue fraudulent transfer claims arising from prepetition transfers is totally dependent upon . . . the issue of whether such claims contained in the Complaint constitute property of the bankruptcy estate, an issue over which the Bankruptcy Court has exclusive jurisdiction."

If the fraudulent transfer claims were property of the estate, Judge Michael said that "only the chapter 7 trustee" would have standing to pursue the claims. As a result, he held that the bankruptcy court did not have discretion to allow the state court to resolve the standing question.

Similarly, Judge Michael said that standing to pursue undisclosed property would turn on whether the claims belonged to the estate. In that respect also, the bankruptcy court did not have discretion to deflect standing questions to the state court.

In denying the motion for sanctions, the bankruptcy court found no violation of the discharge injunction because the investors were attempting to establish the liability of the debtor so they could recover from third parties. As authority, the investors relied on Section 524(e), which provides that a discharge of the debtor "does not affect the liability of any other entity, or the property of any other entity, for such debt."

Judge Michael reversed again. If the claims were property of the estate, and if the investors therefore lacked standing, the safe harbor in Section 524(e) would not apply.

Because the record did not establish whether the claims were estate property, Judge Michael said he could not review the decision to invoke Section 524(e). He therefore reversed and remanded for the bankruptcy court to determine whether the claims were property of the estate, "and, after making that determination, determine whether the Investors had standing to bring those claims."

Bankruptcy Judge Dale L. Somers concurred in the remand but would have the bankruptcy court rule on standing with regard to each count in the complaint, not on the complaint as a whole.

Observations

In an opinion this month, the Third Circuit ruled that the ability of a creditor to sue is not a question of standing, but rather an issue of statutory authority. *See Artesanias Hacienda Real S.A. de C.V. v. North Mill Capital LLC (In re Wilton Armetale Inc.)*, 19-2907, 2020 BL 291772 (3d Cir. Aug. 4, 2020). To read ABI's report, click here.

The Third Circuit held that a creditor ordinarily *will* have standing to pursue a claim belonging to a bankruptcy estate. However, the creditor may lack statutory authority to assert the claim unless the trustee has abandoned the claim or the creditor has suffered a direct, particularized injury.

The Third Circuit therefore would have analyzed the BAP case in terms of statutory authority, not standing. However, the result would be the same, if one assumes that the bankruptcy court has sole jurisdiction to decide whether claims belong to the estate.

The opinion is *Hafen v. Adams (In re Hafen)*, 19-031 (B.A.P. 10th Cir. July 30, 2020).

Equity in property at the time of a hearing, not at filing, decides whether the court should compel abandonment, Sixth Circuit says.

'Snapshot' Rule for Valuation Doesn't Apply to Compelling Abandonment, Circuit Says

The so-called snapshot rule, calling for valuation of a chapter 7 debtor's property as of the filing date, doesn't apply when the debtor moves to compel the trustee to abandon under Section 554(b), the Sixth Circuit held.

Although the appeals court had a case with unusual facts, the holding would probably apply in a typical case.

The chapter 7 debtor owned a home with a $62,000 first mortgage. The home was also subject to a $275,000 second mortgage owing to a bank. The home was worth less than the two mortgages together. Ordinarily, the trustee would abandon a home that was overencumbered. But the facts were more complicated.

When the debtor granted the $275,000 mortgage to the bank before filing, the debtor owed the bank about $1 million arising from his personal guarantee of debts owed to the bank by a defunct business the debtor had owned. As additional security for the $1 million debt, the owner had assigned receivables to the bank that were owing to the debtor by the purchaser of the defunct company's assets. Payments by the asset purchaser would be applied toward the $275,000 mortgage.

The asset purchaser had been making payments to the bank, but the entire $275,000 was still outstanding on the chapter 7 filing date. However, the regular payments being made by the purchaser meant that the entire $275,000 would be paid off about 10 months after the filing date.

About three months after filing, the debtor filed a motion under Section 554(b) to compel the trustee to abandon the home. Employing the snapshot rule, the debtor reasoned there was no equity in the property as of the filing date. The final hearing on the motion to abandon was not held until several months after the $275,000 mortgage had been paid off.

The bankruptcy judge invoked the snapshot rule and granted the motion compelling the trustee to abandon the home, which by that time had substantial equity that the debtor would retain. The bankruptcy judge found as a fact that the $275,000 mortgage was being paid down after filing by the debtor's post-filing income. The trustee appealed, but the district court affirmed.

In an opinion on May 11, Circuit Judge David McKeague reversed.

Judge McKeague began with the proposition that the home was estate property. "The harder question," he said, was whether the equity created after filing was estate property or not. The answer was informed, in part, by Section 541(a)(6), which says that "earnings from services" after filing are not estate property.

In a typical case, the modest equity created after filing is not an estate asset because the debtor would have been paying down the mortgage with post-petition wages "from services." That wasn't true in the case on appeal, however.

Judge McKeague set aside the bankruptcy court's finding that the equity was created by services. There was no evidence in the record to support the finding. Rather, the record revealed that the debtor performed no services for which the purchaser paid down the mortgage.

Judge McKeague then turned to the debtor's second argument: Under the snapshot rule, there was no equity in the home on the filing date. The judge said "it makes little sense to apply the snapshot rule here."

To disregard the snapshot rule, Judge McKeague compared the language in the relevant statutes. Section 541(a)(1) defines estate property to include legal and equitable interests of the debtor "as of the commencement of the case . . . ." Section 554(b), governing motions to compel abandonment, uses the present tense in referring to property that "is burdensome" or "that is of inconsequential value . . . ."

Every court he found that had dealt with "an analogous abandonment dispute" had looked at the equity "at the time the abandonment motion came before it." Furthermore, equity is not the only issue. The circuit had previously held that the court should consider whether "administration of the property will *benefit* the estate," quoting *In re K.C. Mach. & Tool Co.*, 816 F.2d 238, 245 (6th Cir. 1987). [Emphasis in original.]

In the case at bar, Judge McKeague said that a third party "had quickly paid down" the mortgage during the pendency of the bankruptcy case. To compel abandonment "based on nothing more than the snapshot rule and a simple equity calculation — was legal error," he said.

Because the equity did not result from post-petition services, Judge McKeague reversed and directed the bankruptcy court to deny the motion to compel abandonment.

The opinion is *Reisz v. Coslow*, 19-6200 (6th Cir. May 11, 2020).

Fair Debt Collection Practices Act

Even the dissenter in the Ninth Circuit would not let a debt buyer off the hook if the complaint were properly pleaded.

Two Circuits Hold that a Debt Buyer Can Be a 'Debt Collector' Under the FDCPA

Joining the Third Circuit, the Ninth Circuit held 2/1 that a buyer of defaulted debt can be liable under the FDCPA as a "debt collector," even if the buyer has outsourced all of the collection work to a third party.

The decisions by the Third and Ninth Circuits answered one of many questions left open by *Henson v. Santander Consumer USA Inc.*, 137 S. Ct. 1718 (2017), where the Supreme Court held that someone who purchases defaulted debt is not automatically a "debt collector" subject to the federal Fair Debt Collection Practices Act, or FDCPA, 15 U.S.C. § 1692-1692p. Although purchasing consumer debt does not automatically make the buyer a "debt collector" subject to the FDCPA, the two circuits are describing when a debt buyer can be liable for violating the FDCPA.

To read ABI's report on *Henson*, click here.

The Debt Buyer Farms Out Collection Work

The consumer-plaintiff incurred and failed to pay a debt to a jewelry store. The jeweler sold the debt to a third party. In the complaint filed in district court in Oregon, the plaintiff did not allege that the purchaser of the debt had contact with her.

Instead, the plaintiff alleged that the purchaser outsourced debt-collection activities to a debt collector. The complaint claims that the debt collector violated the FDCPA in several respects.

The purchaser of the debt filed a motion to dismiss, arguing that it could not be liable because it did not directly interact with consumers to collect debt. The district court granted the motion to dismiss.

The Circuit's Split Decision

For herself and Circuit Judge Jerome Farris, Circuit Judge Morgan B. Christen reversed the district court and reinstated the lawsuit, with a caveat we will discuss later.

In large part, Judge Christen adopted the rationale of the Third Circuit in *Barbato v. Greystone All. LLC*, 916 F.3d 260 (3d Cir.), *cert. denied sub nom., Crown Asset Mgmt. LLC v. Barbato*, 140 S. Ct. 245 (2019). To read ABI's report on *Barbato*, click here.

To be liable for violating the FDCPA, the defendant must be a "debt collector." The appeals in the Third and Ninth Circuits both turned on the definition of a "debt collector" in 11 U.S.C. § 1962a(6).

A debt collector can be someone who uses interstate commerce "in any business the principal purpose of which is the collection of any debts" or someone "who regularly collects or attempts to collect, directly or indirectly, debts owed or due . . . another." Like the Third Circuit, Judge Christen focused on the "principal purpose" prong of the definition, because the complaint did not allege that the debt purchaser itself collected debts.

The debt purchaser proffered a factual defense by contending that its principal business was buying debt for investment with a view toward turning a profit, not collecting debt. In response, Judge Christen focused on the procedural posture as an appeal from the granting of a motion to dismiss under Rule 12(b)(6) for failure to state a claim.

Under the rule, Judge Christen said the court must accept well-pleaded facts as true and construe them in favor of the plaintiff. In that regard, she characterized the complaint as alleging that the debt buyer's "principal purpose was to buy consumer debts in order to collect on them, and that this is how [the purchaser] generated most or all of its income."

Consequently, Judge Christen said the circuit could not consider the buyer's "fact-based argument." Instead, she looked exclusively to the sufficiency of the pleading.

Persuaded by the Third Circuit's logic, Judge Christen "decline[d] to read a direct interaction requirement into the principal purpose prong based on the phrase 'the collection of any debts.'" If direct interaction were required, she said that the "principal purpose prong would largely collapse the two alternative definitions of debt collector, contrary to the rule that 'we presume differences in language like this convey differences in meaning.'"

The buyer contended that Congress could not have intended to regulate debt buyers who did not themselves collect debt because the debt collection industry did not exist in 1977 when the FDCPA was enacted. Judge Christen said she was "not persuaded" by the argument.

The primary purpose of the FDCPA, Judge Christen said, is to protect consumers. That purpose, she said, "would be entirely circumvented if the Act's restrictions did not apply to entities like" the debt purchaser.

In sum, Judge Christen agreed with the Third Circuit and said that a debt purchaser "cannot avoid liability under the FDCPA merely by hiring a third party to perform its debt collection activities."

The Caveat in the Majority Opinion

Having won the argument that the debt purchaser qualified as a "debt collector" subject to the FDCPA, the plaintiff wasn't out of the woods entirely. At oral argument, the plaintiff's counsel said the district court must be shown on remand that the debt purchaser is vicariously liable according to agency principles.

In other words, it was sufficient for the purpose of Rule 12(b)(6) for the plaintiff to allege that the debt purchaser lacked any business purpose other than debt collection. Those allegations, Judge Christen said, were sufficient allegations to characterize the debt purchaser as a "debt collector," "regardless of whether [the purchaser] outsources debt collection activities to a third party."

On remand, the plaintiff will presumably be required to prove the allegations in the complaint that the debt purchaser is vicariously liable for the actions of the debt collector it hired.

The Dissent

The majority opinion was 13 pages. Circuit Judge Carlos T. Bea wrote a 19-page dissent.

Judge Bea by no means would have insulated the debt buyer from all liability. He began his dissent by noting how the complaint alleged that the buyer controlled the actions of the debt collector to the extent that a jury could find the debt buyer to be liable for the debt collector's actions.

Ordinarily, Judge Bea said, those allegations should have been enough to justify reversal because "the District Court failed to recognize that the complaint sufficiently alleged vicarious liability." However, the plaintiff took the position that vicarious liability would be insufficient without a finding that the debt buyer was also a "debt collector."

That's where Judge Bea disagreed with the majority. He believes that the debt buyer was not a "debt collector" and therefore "owes no FDCPA duties to" the plaintiff. In significant part, he argued that the majority engaged in a "flawed grammatical analysis" of the statute.

At the end of his dissent, Judge Bea said he would have reached the same result as the majority had the plaintiff framed its argument differently. Under established Ninth Circuit law, he said that the debt buyer could be held liable under theories of vicarious liability.

Since the plaintiff abandoned the avenue of vicarious liability, Judge Bea said he would have upheld the district court's dismissal.

The opinion is *McAdory v. M.N.S. & Assoc. LLC*, 18-35923, 2020 Us App Lexis 13301 (9th Cir. March 9, 2020).

Municipal Debt Adjustment & Puerto Rico

Cutting off post-petition liens under PROMESA did not violate the Takings Clause.

Court of Claims Rebuffs Puerto Rico Bondholders' Claims of Unconstitutional Takings

Holders of secured Puerto Rico retirement system bonds lost in their latest effort at squeezing blood out of a rock.

Building on decisions by the Supreme Court and the First Circuit, Judge Richard A. Hertling of the U.S. Court of Claims ruled on November 23 that the federal government was not liable for a Takings Clause violation when bondholders lost their security interest in employer contributions as a consequence of the enactment of the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*).

Bondholders Lose Their Post-Petition Liens

After the Supreme Court ruled that Puerto Rico was ineligible for chapter 9 municipal bankruptcy, Congress quickly adopted PROMESA. Large swaths of chapter 9, governing municipal bankruptcy, are incorporated into PROMESA, including Section 552. With the exception in Section 552(b), Section 552(a) cuts off a prepetition security interest in property acquired after filing.

Including the retirement system, Puerto Rico and many of its instrumentalities sought relief under PROMESA in 2017. In the debt-adjustment proceedings, Puerto Rico's federally appointed Financial Oversight and Management Board effectively represented the retirement system.

At the Oversight Board's behest, the Puerto Rico legislature passed legislation requiring the retirement system to transfer its assets to the commonwealth's general fund. In return, Puerto Rico's government assumed responsibility for paying retirement benefits. The transfer meant that employer contributions went to the general fund, not to bondholders. The Oversight Board took the position that Section 552 cut off the retirement system bondholders' security interest in employer contributions made after filing.

The retirement system bondholders mounted several lawsuits, so far unsuccessfully. At the end of January, the First Circuit upheld the district court and ruled that Section 552 cut off the security interest held by bondholders in contributions made to Puerto Rico's retirement system by employers after filing. *In re Fin. Oversight & Mgmt. Bd. for P.R.*, 948 F.3d 457, 462 (1st Cir. 2020) ("Section 552 Decision"), *cert. denied sub nom. Andalusian Glob. Designated Activity Co.*

v. Fin. Oversight & Mgmt. Bd. for P.R., No. 20-126 (Nov. 16, 2020). To read ABI's report on the January opinion, click here.

In the lawsuit before Judge Hertling, the bondholders raised three claims under the Takings Clause of the Fifth Amendment. They contended there had been unconstitutional takings of (1) their liens and their contractual right to timely payment on the bonds; (2) their liens on post-petition employer contributions, and (3) their contractual right to timely payment from post-petition employer contributions.

In addition to the January First Circuit opinion, Judge Hertling's decision was informed by the Supreme Court's holding on June 1 that the appointment of the Oversight Board did not violate the Appointments Clause of the Constitution because the members were exercising "primarily local duties." *Fin. Oversight & Mgmt. Bd. for P.R. v. Aurelius Inv., LLC*, 140 S. Ct. 1649 (2020). To read ABI's report, click here.

The opinion by Judge Hertling is a *tour de force* on the law of takings. Had he not dismissed the bondholders' claims, federal legislation would often hit a tripwire making the government liable for the impairment of contracts.

The First Claim Fails

The Supreme Court's decision in June led to the demise of the bondholders' first claim, based on the notion that PROMESA effected an unconstitutional taking of their liens. The result turned on whether the Oversight Board was a federal entity.

If the Oversight Board was not a federal entity, the Court of Claims would lack subject matter jurisdiction under the Tucker Act, 28 U.S.C. § 149.

In *Aurelius*, the Supreme Court held that the Oversight Board exercised primarily local duties. Judge Hertling said that "*Aurelius* is dispositive; it speaks to the precise issue the Court needs to address in order to determine its jurisdiction."

The Oversight Board "is an instrumentality of Puerto Rico, not the federal government," Judge Hertling said. Consequently, the bondholders' "first claim therefore is not against the United States as required under the Tucker Act."

Judge Hertling dismissed the first claim after also ruling that the Oversight Board's actions could not be attributed to the U.S.

The Second and Third Claims Fail

The second and third claims were doomed by the First Circuit's decision this year that the bondholders had no enforceable security interest in post-petition contributions. On both claims, the bondholders argued that Section 552 effected a taking of their security interests in post-petition employer contributions.

Unlike the First Circuit, Judge Hertling was looking at the question in terms of an unconstitutional taking, not the operation of Section 552 alone. He reached the same result as the First Circuit because he ruled that the bondholders only held an "expectancy" in post-petition contributions. In a constitutional sense, there could be no taking of property, because the property did not exist on the filing date.

Judge Hertling said that the First Circuit opinion collaterally estopped those bondholders who were parties to the appeal in Boston.

For bondholders not parties to the Boston appeal as to whom collateral estoppel did not apply, Judge Hertling agreed with the First Circuit. He dismissed the second claim, holding that the bondholders "did not have a property interest in their purported liens on post-petition employer contributions. Accordingly, the plaintiffs cannot establish a taking and have failed to state a claim upon which relief can be granted."

The bondholders' third claim likewise failed. He ruled that "Section 552 impaired the plaintiffs' contractual right to post-petition employer contributions, but this impairment does not constitute a taking under the Fifth Amendment. Accordingly, the plaintiffs fail to state a claim upon which relief can be granted."

Judge Hertling explained that the bonds themselves were not "taken." Rather, he said, they were "impaired," and an impairment "is insufficient to support a claim for a taking."

The opinion is *Altair Global Credit Opportunities Fund (A) LLC v. U.S.*, 17-970, 2020 BL 455062 (Ct. Cl. Nov. 23, 2020).

Confirmation appeals in two big cases are dismissed on the same day for equitable mootness.

Tempnology Didn't Undercut the Validity of Equitable Mootness, First Circuit Says

The Supreme Court's *Tempnology* decision did not undercut the validity of the doctrine of equitable mootness used to dismiss appeals from chapter 11 confirmation orders, according to the First Circuit. *See Mission Product Holdings Inc. v. Tempnology LLC*, 139 S. Ct. 1652 (2019). The Boston-based appeals court did say that equitable mootness is more accurately characterized as equitable laches.

The First Circuit's February 8 opinion also held that equitable mootness applies in arrangement proceedings to restructure the debt of Puerto Rico and its instrumentalities under the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*).

On the same day, a district court in Oakland, Calif., invoked equitable mootness to dismiss an appeal from the order confirming the chapter 11 plan for giant electric utility PG&E Corp.

The Cofina Plan

In his opinion for the Boston-based appeals court, Circuit Judge William J. Kayatta, Jr. explained how Puerto Rico created an entity known as Cofina to issue bonds to cover budget shortfalls. The 2006 law granted a statutory lien carving out a portion of sales tax revenue exclusively for Cofino bondholders.

With Puerto Rico, Cofina and the island commonwealth's instrumentalities in PROMESA proceedings, a dispute broke out between the Cofina bondholders and the holders of general obligation bonds. A settlement evolved in mediation that was incorporated into Cofina's plan. The settlement and the plan gave about 54% of sales tax revenue to Cofina bondholders.

Several junior Cofina bondholders objected to the plan and appealed when the plan was confirmed over their objections. The appealing bondholders did not seek a stay, and the plan was consummated. As a result of consummation, Judge Kayatta said that Cofina distributed $322 million to creditors plus $1 billion in sales tax revenues to the commonwealth and Cofina. Newly issued Cofina bonds traded tens of thousands of times, and lawsuits were dismissed with prejudice.

Puerto Rico's Financial Oversight Management Board and others filed a motion to dismiss the appeal as equitably moot.

Equitable Mootness Defined

Like all other circuits, the First Circuit adopted a form of equitable mootness.

The appealing bondholders argued that *Tempnology* made the doctrine invalid, because the Supreme Court decided that the appeal was not moot even though the debtor had distributed all its cash. To read ABI's report on *Tempnology*, click here.

Judge Kayatta dismissed the argument, saying that the Supreme Court decided that the appeal was not moot under Article III because the impossibility of granting any effectual relief had not been shown. Cofina's appeal, he said, did not involve Article III mootness. He conceded there was a "live controversy."

Contrasted to constitutional mootness, Judge Kayatta said that equitable mootness deals with how the court decides a controversy, "not whether we have jurisdiction to decide it." He went on to say that equitable mootness "is perhaps a misnomer."

"The doctrine might better be viewed as akin to equitable laches, the notion that the passage of time and inaction by a party can render relief inequitable," Judge Kayatta said. He went on to justify equitable mootness as a reflection of the bankruptcy court's inherently equitable powers, as shown in venerable Supreme Court decisions such as *Pepper v. Litton*, 308 U.S. 295, 304 (1939).

Having established the viability of equitable mootness, Judge Kayatta needed little more than two pages to rule that the doctrine applies in PROMESA cases. "Nothing in PROMESA undercuts the inherently equitable nature of a proceeding to approve a plan of adjustment," he said.

'They Sat on Their Hands'

With equitable mootness alive and well, Judge Kayatta applied the facts to the law. The appellants, he said, "sat on their hands" by never seeking a stay pending appeal. Their "complete and repeated lack of diligence . . . cuts sharply against them," he said.

Regarding the feasibility of granting the appellants any relief, Judge Kayatta said they "offer no practical way to undo all of this and return to the pre-confirmation status quo."

Judge Kayatta recognized "that, in some cases, it might be possible to modify a stand-alone component of a plan to satisfy an idiosyncratic claim without upsetting the interests of third parties." However, he said that the appellants offered "no relevant stand-alone component [of the plan] that might be modified."

Judge Kayatta dismissed the appeal as equitably moot.

The PG&E Appeal

PG&E, a California utility, confirmed and immediately consummated a chapter 11 plan in July 2020. Among other things, effectuating the plan entailed establishing a $13.5 billion fund for fire victims, creating an $11 billion trust, making $42 billion in disbursements, and issuing new stock plus billions of dollars in debt.

Some creditors objected to the plan and appealed. They objected to provisions in the plan requiring them to exhaust their own insurance coverage before turning to the plan for payment.

The plan had been consummated, District Judge Haywood S. Gilliam, Jr. said, and the appellants offered no "adequate explanation" for failing to pursue a stay pending appeal.

Judge Gilliam could fathom no relief he might grant were he to reverse. Other creditors would be harmed, he said, because they would receive less if the appellants were no longer required to exhaust their own insurance coverage.

Judge Gilliam dismissed the appeal as equitably moot on February 8.

The opinions are *Pinto-Lugo v. Financial Oversight and Management Board for Puerto Rico (In re Financial Oversight and Management Board for Puerto Rico)*, 987 F.3d 173 (1st Cir. Feb. 8, 2021); and *Paradise Unified School District v. Fire Victim Trust*, 20-05414 (N.D. Cal. Feb. 8, 2021).

Cross-Border Insolvency

Another opinion shows that Congress wrote Section 546(e) in a manner that goes far beyond protecting the securities markets in the U.S.

Safe Harbor Bars Foreign Liquidators from Recovering Money Stolen in the U.S.

Congress gave us a statute that allows fraudsters to launder stolen money in the U.S. through foreign banks, as revealed in an opinion by retiring Manhattan Bankruptcy Judge Stuart M. Bernstein.

3

Some of the money stolen by Ponzi-schemer Bernard Madoff went to so-called feeder funds in the British Virgin Islands. The feeder funds then distributed Madoff withdrawals through foreign banks. The feeder funds' BVI liquidators obtained chapter 15 recognition and sued the foreign banks in the bankruptcy court.

Applying the safe harbor in Section 546(e), Judge Bernstein was required in his December 14 opinion to dismiss the liquidators' claims for "unfair preference" and "undervalue transactions." On a motion to dismiss, he allowed constructive trust claims to stand.

The Claims in More Detail

The offshore feeder funds made virtually all of their investments with Madoff. Naturally, they stopped allowing redemptions in 2008 after Madoff was arrested.

The feeder funds ended up in liquidation proceedings in the BVI, where liquidators were appointed. The liquidators obtained recognition of the BVI proceedings as the feeder funds' foreign main proceedings under chapter 15.

The liquidators filed suit in the bankruptcy court against foreign banks that had received redemptions. The complaint alleged that the feeder funds hired a third-party administrator to calculate redemptions. Significantly, the complaint alleges that the administrator knew or was willfully blinded to the fact that the investments in Madoff were worthless.

The complaint also alleges that the defendant in the test case, a London bank, knew that Madoff was conducting a fraud.

In the bank's motion to dismiss, the defendant bank did not challenge the assertions of bad faith and knowledge.

The liquidators sought some $54.5 million in redemptions paid to the London bank in the four years before the Madoff fraud was exposed. The complaint alleged that the redemptions were recoverable under BVI law as "unfair preferences" and "undervalue transactions" and under theories of constructive trust.

Following the Supreme Court's *Merit Management* decision, the bank filed a motion to dismiss, raising issues common to 300 lawsuits filed by the liquidators to recover redemptions. The bank argued that the claims were barred by the so-called safe harbor in Section 546(e). To read ABI's report on *Merit Management Group LP v. FTI Consulting Inc.*, 138 S. Ct. 883 (Feb. 27, 2018), click here.

The Safe Harbor Applies to Some Claims

In brief, Section 546(e) bars avoidance claims that were made to or for the benefit of a "financial institution." The redemptions were paid to a foreign bank.

Citing Sections 101(22)(A) and 741(2), Judge Bernstein said that "a customer of a financial institution such as a bank is also deemed to be a financial institution if the bank acts as the customer's agent in connection with a securities contract." Therefore, the funds themselves were "financial institutions" because they were customers of a bank.

Consequently, avoidance claims against the feeder funds were barred by Section 561(d), which makes the safe harbor applicable in chapter 15 cases.

The liquidators argued that the safe harbor did not apply because the claims were similar to intentional fraudulent transfer claims under Section 548(a)(1)(A). However, Judge Bernstein noted that the liquidators had not made claims based on intentional fraudulent transfers. Indeed, foreign representatives in chapter 15 are not allowed to mount claims under Section 548.

Judge Bernstein read the statute strictly. He said that the exception to the safe harbor for intentional fraudulent transfers "only applies to intentional fraudulent transfer claims under Bankruptcy Code § 548(a)(1)(A)." Furthermore, Judge Bernstein found no analogue in BVI law to claims for intentional fraudulent transfer.

In sum, Judge Bernstein dismissed the liquidators' claims for "unfair preference" and "undervalue transactions" under BVI law as being barred by the safe harbor.

The Constructive Trust Claims

The bank contended that the liquidators' constructive trust claims were preempted by federal law, namely, the safe harbor. Judge Bernstein said that "several courts" have held that state law claims to recover transfers are impliedly preempted by Section 546(e).

Judge Bernstein drew a line, observing that the Supremacy Clause is inapplicable to foreign law. "Courts do not assume that otherwise applicable foreign law is preempted absent express statutory language to that effect," he said.

Finding no express preemption of foreign law, Judge Bernstein denied the motion to dismiss based on BVI constructive trust claims.

Service of Process

Judge Bernstein decided that service of process by mail on foreign defendants was sufficient even though mailed service is not permitted by the Hague Convention. In substance, he held that service by mail on the bank's New York counsel was sufficient under Rule 4(f)(3) of the Federal Rules of Civil Procedure.

Caveat: Don't try this at home. We recommend reading the opinion to identify a foolproof method for serving foreign defendants.

Observations

As interpreted by Judge Bernstein, Congress adopted a statute (the safe harbor) that renders foreign liquidators less able to set aside fraudulent transfers than domestic bankruptcy trustees.

Following the plain language of Section 546(e), Judge Bernstein decided that the exception to the automatic stay for fraudulent transfers with "actual intent" under Section 548(a)(1)(A) does not apply to a foreign law equivalent of Section 548(a)(1)(A).

Judge Bernstein's reading of Section 546(e) means that foreign liquidators cannot avoid fraudulent transfers that could be avoided by domestic bankruptcy trustees.

We respectfully submit that Congress should revisit the issue as part of a thorough overhaul of the safe harbor, including the provisions that turn an ordinary party into a financial institution if a financial institution is the person's agent or the person is a customer of a financial institution.

The opinion is *Fairfield Sentry Ltd v. Amsterdam (In re Fairfield Sentry Ltd)*, 10-03496 (Bankr. S.D.N.Y. Dec. 14, 2020).

Wednesday, April 21, 2021

A fast-food worker can (conceivably) qualify as a small business debtor under Subchapter V, according to Bankruptcy Judge Thomas B. McNamara.

Denver Judge Opens the SBRA Door Wide for People with Debt from Failed Companies

Regarding eligibility for reorganization under the Small Business Reorganization Act, Subchapter V of chapter 11, Bankruptcy Judge Thomas B. McNamara of Denver took a novel approach.

Although the debtor must be *currently* engaged in business at the time of filing, he said that a fast-food worker flipping hamburgers would qualify if half of the debt arose from the "commercial or business activities of the debtor." In other words, in the opinion of Judge McNamara, a debtor's debt must arise from business, but the debtor isn't required to be engaged in that business when she or he files under Subchapter V. The debtor isn't even required to be an owner of the business in which she or he is employed on the filing date.

The Defunct Business

The debtor indirectly owned a business repairing hail damage to cars. He was the sole owner of a limited liability company that in turn owned 30% of the LLC that performed car repairs.

The repair business failed, terminated operations and turned the assets over to the secured lender, leaving the debtor on the hook for about $6.4 million in debt on the repair business that he had personally guaranteed. Losing income from the repair business, the debtor started working as an insurance salesman shortly before filing his chapter 11 petition and asking for treatment as a small business debtor under Subchapter V.

Totaling all of his scheduled debt, the debtor owed about $7.4 million, just below the $7.5 million cap for Subchapter V. Both before and after the chapter 11 filing, the debtor said he was engaged in "winding down" the repair business, although neither he nor the business was generating any income.

The U.S. Trustee and the primary secured creditor of the repair business filed a motion for a declaration that the debtor was not eligible for Subchapter V because he was not currently engaged in business. The Subchapter V trustee supported the debtor by contending that he was eligible.

'Engaged' Means Currently Engaged in Business

In his April 15 opinion, Judge McNamara first tackled the question of whether someone must be engaged in business on the filing date to be eligible for Subchapter V. The question turned on the statute, Section 1182(1)(A), which says that a small business debtor "means a person engaged in commercial or business activities," other than owning single-asset real estate.

Agreeing with the objectors, Judge McNamara applied the test as of the filing date. However, he gave the debtor some leeway by examining the "relevant . . . circumstances immediately preceding and subsequent to the Petition Date as well as the Debtor's conduct and intent." He cautioned that courts should not add qualifiers "where Congress imposed none."

Judge McNamara launched into a lengthy statutory and grammatical analysis. The statute and dictionaries, he said, give an "exceptionally broad" meaning to "commercial or business activities."

Alluding to similar statutory language regarding eligibility for reorganization as a railroad or family farmer, Judge McNamara said that courts require "that a person or entity is presently doing something."

Judge McNamara conceded that there was "some contrary authority," citing *In re Wright*, 2020 WL 2193240 (Bankr. D.S.C. April 27, 2020), where the bankruptcy court held that Subchapter V is not limited to someone engaged in business on the filing date. To read ABI's report on *Wright*, click here.

Previously, Judge McNamara said, the *Collier* treatise did not require being in business on the filing date. He noted, however, that "the treatise authors changed their minds and no longer argue against a temporal restriction as of the Petition Date."

Finally, Judge McNamara cited "more persuasive subsequent case law" requiring engagement in business on the filing date. He cited *In re Johnson*, 2021 WL 825156, at *6 (Bankr. N.D. Tex. Mar. 1, 2021), and *In re Thurmon*, 2020 WL 7249555, at *3 (Bankr. W.D. Mo. Dec. 8, 2020). To read ABI's reports on those cases, click here and here.

At that point, 20 pages into the opinion, it appeared as though Judge McNamara was on the cusp of tossing the debtor out of Subchapter V. Not so fast!

The debtor was still the direct or indirect owner of two LLCs, neither of which had been dissolved by the state. As a manager of both, the debtor continued to have corporate responsibility and was performing some services (albeit limited) in winding down the repair business.

Judge McNamara's next assignment was to distinguish cases he had just cited approvingly, such as *Johnson* and *Thurmon*. In *Johnson*, he said, the businesses had been "dissolved and no longer existed." *Thurmon* was different because the debtor before Judge McNamara still owned two LLCs, one of which was not liquidated and was looking for new business.

The Blockbuster

Two pages from the end, Judge McNamara dropped the blockbuster, based on his understanding of the statute's "exceptionally broad" meaning given to "commercial or business activities." He held that being a "wage earner" selling insurance for someone else still constitutes "commercial or business activity."

Judge McNamara saw "no reason that 'commercial or business activities' are somehow reserved only for business titans, company owners, or management." In other words, he said that "virtually all private sector wage earners may be considered as 'engaged in commercial or business activities.'"

Judge NcNamara nonetheless cautioned that "not . . . every private sector wage earner is eligible for relief under Subchapter V of the Bankruptcy Code. Not at all." More than 50% of the debt must have arisen from "the commercial or business activities of the debtor," as required by Section 1182(1)(A).

"The typical hamburger artist, earning just minimum wage, will almost never be putting his own capital at risk and incurring debts which arise from his work. So, Subchapter V will not be for everyone," Judge McNamara said.

The 26-page opinion boiled down to two significant facts: (1) More than half of the debt was attributable to the debtor's guarantee or his company's obligations, and (2) the debtor was employed selling insurance, although for a company in which he was only an employee and had no ownership interest.

Judge McNamara overruled the eligibility motion and permitted the debtor to proceed toward confirmation.

The opinion is *In re Ikalowych*, 20-17547 (Bankr. D. Colo. April 15, 2021).

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO
Bankruptcy Judge Thomas B. McNamara

In re: JOHN MATTHEW IKALOWYCH, Debtor.	Bankruptcy Case No. 20-17547 TBM Chapter 11 (Subchapter V)

MEMORANDUM OPINION AND ORDER ON CHAPTER 11 (SUBCHAPTER V) ELIGIBILITY

I. Introduction.

Congress recently made a major addition to Chapter 11 of the Bankruptcy Code[1]: the Small Business Reorganization Act of 2019 (the "SBRA").[2] The SBRA (commonly referred to as "Subchapter V"), was designed to streamline the reorganization and rehabilitation process for small business debtors. Substantively, the SBRA lowered the Chapter 11 bar for confirmation of a plan of reorganization by permitting confirmation even if all classes of creditors reject the proposed plan and by eliminating the so-called "absolute priority rule." Procedurally, Congress simplified some of the more cumbersome aspects of standard Chapter 11 cases by eliminating unsecured creditors' committees and disclosure statements. Suffice it to say that the SBRA offers many potential advantages for qualifying Chapter 11 debtors.

Last year, reacting to the Coronavirus pandemic, the Legislative Branch made further temporary changes, expanding SBRA eligibility through enactment of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act").[3] Under Section 1113(a)(1) of the CARES Act, effective for the period from March 27, 2020 to March 27, 2021, a small business "debtor" means:

> . . . [1] a person [2] engaged in commercial or business activities . . . [3] that has aggregate noncontingent liquidated secured and unsecured debts . . . in an amount not more than $7,500,000 . . . [4] not less than 50 percent of which arose from the commercial or business activities of the debtor.

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[1] All references to the "Bankruptcy Code" are to the United States Bankruptcy Code, 11 U.S.C. § 101 *et seq.* Unless otherwise indicated, all references to "Section" are to sections of the Bankruptcy Code.

[2] Pub L. No. 116-54, 133 Stat. 1079 (mainly codified at 11 U.S.C. §§ 1181-1195).

[3] Pub. L. No. 116-136, 134 Stat. 281, 310-12 (2020).

11 U.S.C. § 1182(1)(A). Last month, Congress extended the effectiveness of the foregoing SBRA eligibility provision for another year (through March 27, 2022).[4]

This dispute raises a difficult and novel issue regarding who can use the new SBRA, as modified by the CARES Act. In this bankruptcy proceeding, an individual debtor, John Matthew Ikalowych (the "Debtor"), filed for protection under Chapter 11 and elected Subchapter V. Just before he filed his bankruptcy case, the Debtor started a new job selling commercial insurance products for a company he does not own or control. But, for years, he has been an entrepreneur. He wholly-owns a limited liability company, JMI Management, LLC. ("JMI"), which he uses as a "pass-through" entity for certain business interests. JMI, in turn, owns a 30 percent interest in a second limited liability company, Lyceum Hailco, LLC ("Hailco"), which operated an automotive hail repair business. The Debtor worked for and managed Hailco. Hailco experienced financial difficulties shortly before the Debtor's bankruptcy filing. As a result, it "cease[d] operations and surrender[ed] all of its assets." The failure of Hailco triggered the Debtor's own bankruptcy because he had personally guaranteed most of Hailco's debts. Hailco's failure also forced the Debtor to switch jobs to earn a living. However, in fulfillment of his management duties to Hailco, the Debtor continued to perform a modest amount of "wind down" work for Hailco both before and after the Debtor's bankruptcy petition.

The United States Trustee (the "UST") objected to the Debtor's designation and eligibility under Subchapter V of Chapter 11. The UST contends that the Debtor is not eligible to be a small business debtor because the Debtor was not "engaged in commercial or business activities" when he filed for bankruptcy. The Debtor contests the UST's objection and asserts that he is eligible to be a Subchapter V debtor by virtue of his full ownership of JMI and indirect ownership of Hailco, as well as his "wind down" work for Hailco. In the end, the dispute boils down to whether the Debtor qualifies as "a person engaged in commercial or business activities" within the meaning of Section 1182(1)(A) and eligible to be a debtor in Subchapter V.

II. Jurisdiction and Venue.

This Court has jurisdiction to enter final judgment on the eligibility issues presented in this bankruptcy case pursuant to 28 U.S.C. § 1334. Eligibility for relief under Chapter 11 (Subchapter V) is a core matter under 28 U.S.C. §§ 157(b)(2)(A) (matters concerning administration of the estate) and (b)(2)(O) (other proceedings affecting the liquidation of the assets of the estate). Venue is proper in this Court pursuant to 28 U.S.C. §§ 1408 and 1409.

[4] *See* COVID-19 Bankruptcy Relief Extension Act of 2021, Pub. L. 117-5 (Mar. 27, 2021).

III. Procedural Background.

A. The Bankruptcy Filing and Subchapter V Election.

The Debtor filed for protection under Chapter 11 of the Bankruptcy Code on November 20, 2020 (the "Petition Date").[5] In Section 12 of his Petition, the Debtor checked the "No" box in response to the question: "Are you a sole proprietor[6] of any full- or part-time business?"[7] In Section 13 of his Petition, the Debtor checked the "Yes" box in response to the statement:

> I am filing under Chapter 11, I am a debtor according to the definition in § 1182(1) of the Bankruptcy Code, and I choose to proceed under Subchapter V of Chapter 11.[8]

The Court refers to the Debtor's decision to proceed under Chapter 11 (Subchapter V) as the "Subchapter V Election." Later in his Petition, the Debtor characterized his debts as "primarily business debts."[9] On February 5, 2021, the Debtor filed his "Sub-Chapter V Plan of Reorganization" (the "Plan").[10] The Plan has not been confirmed.

B. The Eligibility Objection, Response, and Joinders.

The UST objected to the Debtor's Subchapter V Election by filing the "U.S. Trustee's Objection to Debtor's Designation as a Subchapter V Small Business Debtor" (the "Eligibility Objection").[11] The central thrust of the Eligibility Objection is the assertion that the Debtor is not "engaged in commercial or business activities" within the meaning of Section 1182(1)(A). The Debtor's largest creditor, Sunflower Bank N.A. ("Sunflower Bank"), joined in the UST's Eligibility Objection and also contends that the Debtor may not use Subchapter V.[12]

The Debtor filed a "Response" to the Eligibility Objection, contesting the UST's position and arguing that the Debtor correctly elected to proceed under Subchapter V since he is "engaged in commercial or business activities" within the meaning of Section 1182(1)(A) (the "Response").[13] The Subchapter V Trustee, John C. Smiley (the "Subchapter V Trustee"), agrees with the Debtor and joined in the Debtor's Response.[14]

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5 Ex. 1; Stip. Fact No. 1.

6 Section 12 of the Petition states: "A sole proprietorship is a business you operate as an individual, and is not a separate legal entity such as a corporation, partnership, or LLC." Ex. 1 at 4.

7 Ex. 1 at 4 § 12.

8 Ex. 1 at 4 §13; Stip. Fact No. 1.

9 Ex. 1 at 6 § 16b.

10 Ex. 3.

11 Docket No. 30.

12 Docket No. 45.

13 Docket No. 38.

14 Docket No. 46.

C. The Hearings.

The Court conducted a preliminary non-evidentiary hearing on the Eligibility Objection, Response, and Joinders on February 19, 2021.[15] Thereafter, the parties submitted their "Statement of Stipulated Facts," listing a set of eight stipulated facts (the "Stipulated Facts").[16] However, the parties noted that they were unable to agree to certain additional facts proposed by the Debtor. Accordingly, the Court conducted a second preliminary non-evidentiary hearing on March 11, 2021, during which the parties requested that the Court set the dispute for a trial.[17] The Court agreed and conducted an evidentiary hearing on the eligibility issues on March 24, 2021.[18] At the trial, the Court heard testimony from the Debtor and admitted into evidence the UST's Exhibits 1-7 and the Debtor's Exhibits A-D. After the trial, the Court took the dispute under advisement. The Subchapter V eligibility issues are now ripe for decision.

IV. Factual Findings.

Based upon the Stipulated Facts, the evidence presented at the trial (including the testimony of the Debtor and the admitted exhibits), as well as the Debtor's Petition, Statement of Financial Affairs, Schedules, and other record bankruptcy filings, the Court makes the following findings of fact under Fed. R. Civ. P. 52(a)(1), as incorporated by Fed. R. Bankr. P. 7052.

A. The Debtor's Employment on the Petition Date and Thereafter.

As set forth below, the Debtor was employed by Hailco for several years and also served as one of the managers of Hailco. He stopped working for Hailco sometime between September 26 and October 2, 2020[19], because Hailco was winding down its business and ceased operations. The Debtor was unemployed for most of October 2020.[20] Then, just weeks before the Petition Date (sometime between October 25 and November 7, 2020), he started as an employee with CCIG, an insurance brokerage company.[21] The Debtor's role at CCIG is as a "Commercial Insurance Producer" selling commercial insurance products.[22] The Debtor does not have an ownership interest in CCIG; instead, he is only an employee.[23] CCIG pays the Debtor a monthly salary of about $11,250.00.[24] The Debtor also may be eligible for a potential annual bonus. The Debtor has continued to work at CCIG since the Petition Date.

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15 Docket No. 57.
16 Docket No. 68.
17 Docket No. 72.
18 Docket No. 80.
19 Docket No. 4 at 2-4.
20 Ex. 3 at 5("The Debtor was unemployed at the time [October 8, 2020].").
21 Docket No. 4 at 1
22 Ex. 1 at 47; Stip. Fact No. 8.
23 Stip. Fact No. 8; Ex. 1 at 47.
24 Ex. 2.

B. The Debtor's Relationship with Lyceum Hailco, LLC.

Hailco is a Colorado limited liability company that nformerly operated as an automotive hail repair business performing paintless dent repair.[25] The management of Hailco is vested in managers. The Debtor is one of the managers of Hailco.[26] For several years prior to the Petition Date, the Debtor worked for Hailco. However, he stopped working for Hailco between September 26 and October 2, 2020, because the entity failed financially. At the same time (*i.e.*, in early October 2020), Hailco ceased operations and surrendered all of its assets to Sunflower Bank.[27]

In various filings made in his bankruptcy case, the Debtor asserted that he "owned" Hailco. For example, in his "Subchapter V Status Report" and also in his Plan, the Debtor informed the Court and parties in interest that:

> The Debtor owned and operated a hail repair business, Lyceum Hailco, LLC located at 2452 S. Trenton Way, Unit F, Denver, Colorado 80231. Due to COVID, a lack of hailstorms, and a significantly deficient payout on an insurance claim, Hailco was forced to cease operations and surrender its assets to its secured lender [Sunflower Bank]. The Debtor's bankruptcy filing was prompted by the Debtor's personal guarantee of a number of Hailco's obligations. In addition, the Debtor was unemployed until just prior to the Petition Date.[28]

More specifically, he stated that he owned 30 percent of the membership interests of Hailco.[29] The Debtor repeatedly has confirmed that the value of his equity in Hailco is "$0.0."[30] Consistent with the Debtor's valuation of his minority interest in Hailco as worth "$0.0," Hailco's Balance Sheet shows that its liabilities far exceed its minimal assets so that there is no equity in the company.[31]

Notwithstanding, at trial, the Debtor testified that he does not actually own any of the membership interests in Hailco. Instead, the Court finds that the Debtor's equity role in Hailco is indirect. The Debtor wholly owns JMI, a Colorado limited liability company. In turn, JMI — not the Debtor — owns a 30 percent membership interest in Hailco. The Court did not receive any specific testimony concerning all the other persons or entities who own the remaining membership interests in Hailco.

In any event, starting prior to the Petition Date and continuing after the Petition Date, Hailco has been winding down its business and financial affairs (including by

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25 Stip. Fact No. 2; Docket No. 28 at 8.
26 Claim No. 3-1 at 11 and 17.
27 Stip. Fact No. 3.
28 Ex. 2; Ex. 3 at 2; *see also* Stip. Fact No. 3.
29 Docket No. 21 at 1 and 8.
30 Ex. 1 at 27; Ex. 3.
31 Docket No. 21 at 14; Ex. 3 at 3.

surrendering all of its assets during October 2020).[32] The Debtor has been assisting Hailco in its wind down, both prior to and after the Petition Date. In terms of the actual activities the Debtor has performed for Hailco as part of the wind down of Hailco, the Debtor testified that he:

- Interacted with Hailco's lenders concerning Hailco's wind down;
- Interfaced with Hailco's landlord regarding Hailco's wind down;
- Helped with physical cleanup of Hailco's leased premises and turnover of the premises to Hailco's landlord;
- Assisted in addressing payroll issues for Hailco's former employees;
- Dealt with Form 1099 issues for Hailco's vendors;
- Communicated with Hailco's tax accountants;
- Interfaced with Hailco's bookkeeper regarding Hailco's PPP loan and final close-out of financials;
- Worked on Hailco's business records retention and storage (including transitioning Quickbooks files from a cloudbased system); and
- Considered Hailco's intellectual property and website issues.

The Court accepts that the Debtor performed such work, which the Court refers to as the "Wind Down Work." However, the timing is a little vague. The Debtor did not identify which specific parts of the Wind Down Work were performed before he filed for bankruptcy protection, and which occurred after the Petition Date. The Debtor testified that he spent about 12 hours a month on the Wind Down Work and that he "forecasts" a future reduction in time on such projects. The Debtor did not receive any compensation for his Wind Down Work. The Debtor still is a manager of Hailco. And, Hailco continues to exist as a Colorado limited liability company — it has not been dissolved under COLO. REV. STAT. §§ 7-80-801 *et seq.*

The Debtor's Plan does not contemplate the Debtor's receiving any income from Hailco nor taking any other action with respect to Hailco.[33] Instead, the Debtor's main

[32] Stip. Fact No. 4.
[33] Ex. 3.

source of income for the Plan is from CCIG, albeit a small amount of income is projected from JMI.[34]

C. The Debtor's Relationship with JMI Management, LLC.

The Debtor formed JMI as a Colorado limited liability company in 2012 and owns 100% of the membership interests in JMI.[35] The Court deduces that the "JMI" acronym stands for the Debtor's full name: John Matthew Ikalowych. In addition to wholly owning JMI, the Debtor also serves as the sole manager of JMI.[36] The Debtor testified that he formed JMI as a business vehicle for his "non-W-2" income and work. He repeatedly has confirmed that the value of his equity in JMI is "$0.0."[37] JMI existed prior to the Petition Date and continues to exist after the Petition Date.[38]

From approximately 2012 to 2014 (or possibly 2015), the Debtor used JMI to provide property management services in relation to several units of leased residential real property.[39] However, JMI has not provided property management services since 2014. After 2012, the Debtor has served on the Board of Directors of Fairmount Cemetery, earning approximately $3,000.00 per year for that role.[40] Although the Debtor, not JMI, serves on the Board of Directors of Fairmount Cemetery, he directed Fairmont Cemetery to pay his Board of Directors fee to JMI. So, the Fairmont Cemetery income has been received by JMI and has flowed through from JMI to the Debtor.[41] The reason for that arrangement is a bit unclear. The Debtor testified that he was advised by a "tax accountant" to open JMI.

The Debtor's Federal Income Tax Return Schedule C for 2017 shows that JMI received $3,000.00 from Fairmont Cemetery.[42] JMI's expenses were $5,382.00. So, JMI generated a net loss of $2,382.00 in 2017.[43] Something similar happened in 2018: JMI received $3,000.00 from Fairmont Cemetery and the Debtor listed $4,526.00 as JMI's expenses, resulting in a net loss for JMI of $1,526.00.[44] The next year, 2019, JMI also received $3,000.00 from Fairmont Cemetery.[45] However, the Debtor (through JMI) claimed various expenses and a $21,642.00 depreciation deduction for a new model BMW X5.[46] The result was that JMI asserted a $27,198.00 loss.[47]

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34 *Id*.
35 Stip. Fact No. 5.
36 *Id*.
37 Ex. 1 at 27; Ex. 3.
38 Stip. Fact No. 5.
39 *Id*.
40 *Id*.; *see also* Exs. A-C (Federal Income Tax Returns Schedule C for 2017-2019 showing $3,000.00 annual payments to JMI on the Debtor's Tax Returns.)
41 Stip. Fact No. 5.
42 Ex. A.
43 *Id*.
44 Ex. B.
45 Ex. C.
46 *Id*.
47 *Id.* The BMW X5 tax write-off by JMI seems odd since the Debtor claimed that he owned the vehicle on his Schedule A/B and asserted a personal exemption in the car on his Schedule C. (Docket

The Profit and Loss Statement for JMI for the period of January 1, 2020, through December 3, 2020, included with the Debtor's "Periodic Report Regarding Value, Operations, and Profitability of Entities in Which the Debtor's Estate Holds a Substantial or Controlling Interest,"[48] shows the following receipts and disbursements for JMI during that period:

Lyceum HailCo Management Fees	$ 7,470.05
Fairmount Cemetery Board Fees	$ 3,000.00
	$ 10,470.05
Distributions to John Ikalowych	$(10,470.04)
Remaining Balance:	$ 0.01

So, JMI received some income from Hailco. The Periodic Report also states that "[t]here is no balance sheet for JMI Management, LLC as it is a pass-through entity."[49]

JMI has not been dissolved under COLO. REV. STAT. §§ 7-80-801 *et seq.* Instead, the Debtor apparently intends for JMI to engage in some business. Several months after the Debtor filed for bankruptcy protection, JMI entered into a "Business Consulting Agreement" with SkyHelm pursuant to which JMI agreed to provide certain business consulting services to SkyHelm for $2,500.00.[50] The Debtor signed the agreement as Managing Member of JMI. JMI has not received any payments from SkyHelm in relation to the new contract yet. The Plan does not contemplate the Debtor's receiving any income from JMI or taking any other action with respect to JMI, except that the Debtor apparently expects to receive $2,100.00 per year as a "dividend" from JMI for the $3,000.00 Board of Directors fee that JMI receives from the Fairmont Cemetery.[51]

D. <u>The Debtor's Debts</u>.

On his Schedules, the Debtor identified just fifteen creditors holding aggregate claims totaling $7,396,750.09.[52] In terms of the type of debt owed by the Debtor, he states that eight of his creditors hold claims for "business debt of Lyceum Hailco, LLC that Debtor guaranteed."[53] As explained previously, the Debtor has an indirect minority equity interest in Hailco through his ownership of JMI. The Debtor's largest creditor is Sunflower Bank. According to the Debtor, he owes Sunflower Bank $4,328,789.00, which amount is not contingent, unliquidated or disputed.[54] Sunflower Bank submitted a Proof of Claim (Claim No. 3-1) in a slightly higher amount: $4,364,744.99. The Sunflower Bank debt is based upon a loan to Hailco which was guaranteed by the Debtor and secured by the assets of Hailco as well as by the Debtor's membership

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No. 1 at 25 and 33.) It is all a bit confusing, but probably not of great moment for purposes of the current dispute.

48 Docket No. 21 at 17.

49 *Id.* at 4.

50 Ex. D.

51 Ex. 3 at 24.

52 Ex. 1 at 22-42.

53 *Id.* at 17-21.

54 *Id.* at 20, 35.

interest in Hailco.[55] There are seven other creditors who also have claims based upon the Debtor's guarantee of Hailco debt. Altogether, the claims against the Debtor premised on the Debtor's guarantee of Hailco debt total $6,388,756.03.[56]

E. The Debtor's Post-Bankruptcy Monthly Operating Reports.

In his "Monthly Operating Report for Small Business Under Chapter 11," for the month of November 2020 (the "November 2020 MOR"), the Debtor was asked:

> Did the business operate during the entire reporting period?
>
> Do you plan to continue to operate the business next month?
>
> Did you pay your employees on time?
>
> Have you deposited all the receipts for your business into debtor in possession (DIP) accounts?[57]

The Debtor answered "N/A [Not Applicable]" to all of the foregoing questions. The November 2020 MOR shows that the Debtor received income from only CCIG every two weeks.[58] The November 2020 MOR also shows that the Debtor did not pay any expenses for operating a business.[59] Instead, all of the Debtor's significant monthly expenses appear to be for typical consumer-type living expenses; such as food, clothing, telephone, and medical expenses. The Debtor attached an explanation to the November 2020 MOR explaining why he was not earning business income or paying business expenses. He wrote: "Lyceum Hailco was shut down the end of September [2020] and has not operated since."[60] He also noted that "I recently started working" at CCIG.[61]

In his "Monthly Operating Report for Small Business Under Chapter 11," for the month of December 2020 (the "December 2020 MOR"), the Debtor answered the Business Operations Questions the same way as the November 2020 MOR.[62] And again, the December 2020 MOR shows that the Debtor received income (salary) from only CCIG every two weeks. He had no other business income and no business expenses.[63]

In his "Monthly Operating Report for Small Business Under Chapter 11," for the month of January 2021 (the "January 2021 MOR"), the Debtor answered the Business

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55 Ex. 1 at 20, 35; Claim No. 3-1; Stip. Fact No. 2.
56 *Id.*
57 Ex. 4 at 1.
58 *Id.* at 6-10.
59 *Id.*
60 *Id.* at 25.
61 *Id.*
62 Ex. 5.
63 *Id.*

Operations Questions the same way as the November 2020 MOR.[64] And again, the January 2021 MOR shows that the Debtor received income (salary) from only CCIG every two weeks. He had no other business income and no expenses.[65]

V. Legal Analysis.

A. Statutory Framework for Subchapter V Eligibility.

The Court's eligibility analysis starts — as it must — with the text of the applicable statute. Section 1182 defines the term "debtor" in Subchapter V cases:

> (1) Debtor. The term *"debtor"* —
>
> (A) subject to subparagraph (B), *means a person engaged in commercial or business activities* (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning single asset real estate) 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* (excluding debts owed to 1 or more affiliates or insiders) *not less than 50 percent of which arose from the commercial or business activities of the debtor*; and
>
> (B) does not include —
>
> (i) any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $7,500,000 (excluding debt owed to 1 or more affiliates or insiders);
>
> (ii) any debtor that is a corporation subject to the reporting requirements under section 13 or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78*o*(d)); or
>
> (iii) any debtor that is an affiliate of an issuer, as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c).

11 U.S.C. § 1182 (emphasis added).

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64 Ex. 6.

65 *Id.*

So, structurally, Section 1182(1)(A) identifies who generally qualifies as a Subchapter V debtor. Then, Section 1182(1)(B) lists exceptions to the general rule. The exclusions in Section 1182(1)(B) are not applicable in this dispute because the Debtor is not a "member of a group of affiliated debtors," not a "corporation" subject to reporting requirements under 15 U.S.C. §§ 78m or 78o(d), and not an "affiliate of an issuer" under 15 U.S.C. § 78c. Thus, in this case, the eligibility focus rests exclusively on Section 1182(1)(A).[66]

The Section 1182(1)(A) statutory text lists four discrete requirements for Subchapter V eligibility. Changing the order just slightly for ease of legal analysis, the mandatory elements are:

(1) the Debtor must be a "person";

(2) the Debtor's aggregate debt as of the Petition Date must not exceed $7,500,000;

(3) the Debtor must be "engaged in commercial or business activities"; and

(4) 50% or more of the Debtor's debt must have arisen from "the commercial or business activities of the [D]ebtor." *Id*.

The Debtor bears the burden to prove his eligibility under Subchapter V. *In re Sullivan*, ___ B.R. ___, 2021 WL 1250805, at *2 (Bankr. D. Colo. Mar. 30, 2021). *Cf. First Nat'l Bank of Durango v. Woods (In re Woods)*, 743 F.3d 689, 705 (10th Cir. 2014) ("Debtors had the burden of establishing their eligibility for Chapter 12 relief."); *Hamilton Creek Metro. Dist. V. Bondholders Colo. Bondshares (In re Hamilton Creek Metro. Dist.)*, 143 F.3d 1381, 1384-85 (10th Cir. 1998) (debtor bears burden to show eligibility under Chapter 9 of Bankruptcy Code). The Court will consider each of the mandatory elements in turn.

B. The Debtor Meets the "Person" Requirement.

The first Section 1182(1)(A) requirement is that the Debtor must be a "person." In Section 101(41), Congress defined the term "person" as: "includes individual, partnership, and corporation . . . ." Under such definition, the Debtor is a "person." Neither the UST nor Sunflower Bank suggests otherwise.

[66] In its arguments at the evidentiary hearing, Sunflower Bank argued that the Debtor was not eligible to be a Subchapter V debtor because it was not he, but Hailco, that was engaged in "commercial or business activities." Therefore, Sunflower Bank argued, the Debtor could qualify to be a debtor under Subchapter V only if Hailco filed for bankruptcy, thereby rendering the Debtor an "affiliate of such person that is also a debtor," as provided in Section 1182(1)(A). Sunflower Bank's argument was creative; however, since the Court determines that the Debtor himself was engaged in "commercial or business activities" for his benefit as well as the benefit of Hailco, the "affiliate of such person that is also a debtor" parenthetical — whatever it might mean —is inapposite to the case at hand.

C. The Debtor Satisfies the $7,500,000 Debt Cap.

Section 1182(1)(A) contains a debt cap mandating that the Debtor's "aggregate noncontingent liquidated secured and unsecured debt" as of the Petition Date is "not more than $7,500,000." On his Schedules, the Debtor identified just fifteen creditors (of all types, including secured, unsecured priority, and unsecured) holding aggregate claims of $7,396,750.09. That amount of debt is remarkably close to $7,500,000. But even without considering which debts are "noncontingent" or "liquidated," the total still is below the $7,500,000 limit. As an additional check, the Court consulted the Debtor's official Claims Register. Very few creditors filed claims so far. But, the balance remains lower than the $7,500,000 threshold. Neither the UST nor Sunflower Bank contests that the Debtor's aggregate debt falls below the debt cap. So, the Debtor meets the Section 1182(1)(A) debt limit.

D. The Debtor Passes the Two "Commercial or Business Activities" Requirements.

Section 1182(1)(A) contains two additional, separate but closely related, elements both utilizing the same phrase: "commercial or business activities." First, the Debtor must be a person "engaged in commercial or business activities." Second, "not less than 50%" of the Debtor's "aggregate noncontingent liquidated secured and unsecured debts" must have arisen from "the commercial or business activities of the [D]ebtor."

Since these two discrete elements contain a common phrase, the Court has grouped the requirements together for legal scrutiny. And, besides, both mandates are very closely linked in how they operate. The first element establishes a general requirement: the Debtor be "engaged in commercial or business activities." The second reins in the general requirement quite substantially: half or more of the Debtor's aggregate debt must have arisen from those same "commercial or business activities." The requirements must be read in tandem.

1. "Commercial or Business Activities" Is an Exceedingly Broad Phrase.

The phrase "commercial or business activities" is unique from a federal statutory perspective. The term does not appear in any current federal statute except for the Bankruptcy Code: Sections 1182(1)(A) and 101(51D), both of which pertain to small business debtors.[67] Since the phrase "commercial or business activities" is not expressly defined in the Bankruptcy Code and the UST challenges the point in the Eligibility Objection, the Court must engage in a statutory interpretation exercise.

When construing a statute, the Court employs a fair reading method that dictates the primacy of the statutory text. The inquiry must center on the "language of the

[67] Section 707(b)(5)(C) contains a similar phrase in defining a "small business": "commercial or business activity."

statute itself." *Ransom v. FIA Card Servs., N.A.*, 562 U.S. 61, 69 (2011) (quoting *U.S. v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989)). The starting place is the "plain" or "ordinary" meaning of the text. *Clark v. Rameker*, 573 U.S. 122, 127 (2014); *Hamilton v. Lanning*, 560 U.S. 505, 513 (2010). And, the Court's duty is "to give effect, if possible, to every clause and word of a statute." *U.S. v. Menasche*, 348 U.S. 528, 538-39 (1955) (quoting *Inhabitants of Montclair Tp. v. Ramsdell*, 107 U.S. 147, 152 (1883)); *Lowe v. SEC.*, 472 U.S. 181, 207 n.53 (1985) ("[W]e must give effect to every word that Congress used in the statute.").

None of the parties to this dispute really explained the term "commercial or business activities," except that the Debtor and the Subchapter V Trustee both contended that the concept is very encompassing. The Court concurs and concludes that the plain or ordinary meaning (*i.e.,* the meaning understood by a typical speaker of the English language) of the phrase "commercial or business activities" is exceptionally broad.

The Court decides from review of the text, and applying ordinary or plain meaning, that the term "commercial or business activities" means any private sector actions related to buying, selling, financing, or using goods, property, or services, undertaken for the purpose of earning income (including by establishing, managing, or operating an incorporated or unincorporated entity to do so). "Commercial or business activities" may be contrasted with sovereign or governmental activities which a private-sector actor may not perform. Furthermore, consumer consumption transactions generally are not considered to be "commercial or business activities" (at least from the perspective of the consumer debtor) since such transactions are not undertaken to earn income. *See Sullivan*, 2021 WL 1250805, at *2-5 (suggesting that "consumer debt" is not "commercial or business" debt). So, in the end, "commercial or business activities" covers a lot.

Textual clues in Section 1182(1)(A) also support such an expansive view of the "commercial or business activities" requirement. For example, the statute contains a parenthetical which excludes from eligibility "a person whose primary activity is the business of owning single asset real estate." At least two lessons can be gleaned from that parenthetical. First, qualifying "business activity" generally can include "owning" something (other than "single asset real estate") such as owning equity in a company or owning a fleet of taxis. Second, Congress used the word "primary" as a qualifier in the parenthetical but not the main part of the text. The use of "primary" in one place but not the other suggests that "commercial or business activities" do not need to be the "primary" activities of a debtor. It will be enough if the debtor engaged in some "commercial or business activities" provided that all the other elements of Section 1182(1)(A) are met.

Congress chose to use an extremely broad phrase: "commercial or business activities," without further qualifiers. The absence of qualifiers does not suggest, however, that the judiciary should impose its own limits or exclusions where Congress has imposed none. Instead, under the "general-terms canon" of statutory interpretation,

"the presumed point of using general words is to produce general coverage — not to leave room for courts to recognize ad hoc exceptions . . . . [I]n the end, general words are general words, and they must be given general effect." Antonin Scalia and Bryan A. Garner, READING LAW: THE INTERPRETATION OF LEGAL TEXTS 101 (Thompson/West 2012) [hereinafter, "READING LAW"]. Utilization of general words "demonstrates breadth." *Pa. Dep't of Corr. v. Yeskey*, 524 U.S. 206, 212 (1998) (quoting *Sedima, S.P.R.L. v. Imrex Co.*, 473 U.S. 479, 499 (1985)).

In any event, the Court derived the foregoing understandings of the phrase "commercial or business activities" primarily from the text and considerations of the language used by Congress. However, the Court also has considered multiple other sources, including dictionaries, statutes, and case law, which all lead to the conclusion that the phrase "commercial or business activities" is very broad and encompassing.

a. Dictionary Definitions.

According to the Supreme Court, dictionaries can help determine the ordinary meaning of words and phrases contained in the Bankruptcy Code. *City of Chicago, Illinois v. Fulton*, 141 S. Ct. 585, 590 (2021) (using dictionaries to define words "act" and "exercise" in Bankruptcy Code); *Lamar, Archer & Cofrin, LLP v. Appling*, 138 S. Ct. 1752, 1759 (2018) (using dictionaries to define words "statement" and "respecting" in Bankruptcy Code); *Baker Botts L.L.P. v. ASARCO LLC,* 576 U.S. 121, 128 (2015) (using dictionaries to define word "services" in Bankruptcy Code); *Clark*, 573 U.S. at 127 (using dictionaries to define words "retirement" and "funds" in Bankruptcy Code); *Ransom*, 562 U.S. at 69 (using dictionaries to define word "applicable" in Bankruptcy Code). Unfortunately, dictionaries generally define words — not phrases such as "commercial or business activities." But, the Court can consider the constituent parts of the entire phrase: the adjective "commercial"; the adjective "business"; and the noun "activities."

One of the more prominent and popular United States dictionaries frequently referenced by the Supreme Court as authoritative defines "commercial" as "of, in, or relating to commerce." WEBSTER'S THIRD NEW INT'L DICTIONARY 456 (G. & C. Merriam Co. 1968). And "commerce" means "the exchange or buying and selling of commodities." *Id*. Other definitions of "commercial" and "commerce" are similar. *See* AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 370 (Houghton Mifflin Harcourt 5th ed. 2011) ("commercial" means "of or relating to commerce"; "commerce" means "the buying and selling of goods"); Bryan A. Garner, BLACK'S LAW DICTIONARY 325 (Thompson Reuters 10th Ed. 2014) ("commercial" means "of, relating to, or involving the buying and selling of goods").

The word "business" means "usu. commercial or mercantile activity customarily engaged as a means of livelihood." WEBSTER'S THIRD NEW INT'L DICTIONARY 302 (G. & C. Merriam Co. 1968). Or, put another way, "business" means "the activity of buying and selling commodities, products, or services" or "a specific occupation or pursuit." AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 252 (Houghton Mifflin

Harcourt 5th ed. 2011); *see also* Bryan A. Garner, BLACK'S LAW DICTIONARY 239 (Thompson Reuters 10th ed. 2014) ("business" means "a commercial enterprise carried out for profit; a particular occupation or employment habitually engaged in for livelihood or gain").

So, the words "commercial" and "business" are clearly synonyms. But "business" might be just a little bit broader in the sense of encompassing services (in addition to goods) and the idea of earning income through occupation or employment. As used in Section 1182(1)(A), both "commercial" and "business" modify "activities." The word "activities" mainly connotes "actions," "functions," or "processes." *See* WEBSTER'S THIRD NEW INT'L DICTIONARY 22 (G. & C. Merriam Co. 1968); *see also* AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 17 (Houghton Mifflin Harcourt 5th ed. 2011) (similar). "Activities" is plural. So, that means more than just one event and suggests continuous, recurring, or ongoing action. Finally, the conjunction "or" in the phrase "commercial or business activities," expands the phrase to include as alternatives both "commercial activities" and "business activities."

Interpretation of statutory phrases can be aided by considering the definitions of each of the words in a phrase; but simply stringing separate dictionary definitions together is not enough and might lead in the wrong direction. Instead, the Court must consider context and purpose in applying definitions. The phrase "commercial or business activities" is located in the Bankruptcy Code. So, the overall context is the economic or financial sphere. The term "commercial or business activities" also is preceded by the word "person." And since "person" includes both individuals and entities (both incorporated and unincorporated), that means that "commercial or business activities" are the types of actions which can be performed by either individuals or companies.

In any event, the Court observes from the dictionary definitions that "commercial or business activities" is a very broad and encompassing phrase. Such definitions further support the Court's own previously-explained ordinary meaning conclusion.

b. Statutory Analogs.

The specific phrase "commercial or business activities" cannot be found in any federal statutes other than Sections 1181(1)(A) and 101(51D) of the Bankruptcy Code. However, reference to analogous phrases in other statutes may inform the Court's understanding of the terminology.[68] Since the text of the Bankruptcy Code should be construed consistently and as a whole, the Court starts its statutory search for analogous provisions in the Bankruptcy Code. *See* READING LAW at 167 (explaining the "whole-text cannon" and that the text must be construed as a whole).

[68] Looking to other statues for meaning clearly is not dispositive since the same word or phrase may be defined differently statute by statute. And, the context (which matters) may vary greatly. However, being careful to recognize the foregoing, helpful clues still may emerge.

The Bankruptcy Code does not provide much help with analogous provisions, except in Section 1304. That part of the Bankruptcy Code deals with "Adjustment of Debts of an Individual With Regular Income." Assuming that a debtor is eligible for protection under Chapter 13, Section 1304 provides some guidance about what a Chapter 13 debtor who is "engaged in business" can do. Under Section 1304(a): "A debtor that is self-employed and incurs trade credit in the production of income from such employment is engaged in business." Section 1304(b) generally allows "a debtor engaged in business" to continue to "operate the business." None of this is directly applicable to Subchapter V. However, Section 1304(a) suggests that incurring trade credit is a type of "business" activity and also makes clear that the production of income is an important aspect of business.

Outside of bankruptcy, the Court has considered other federal statutes dealing with a component part of the phrase "commercial or business activities": "commercial activities." The term "commercial activities" is used in a few dozen federal statutes, usually in the context of distinguishing "commercial activities" from governmental action. *See*, *e.g.*, 33 U.S.C. § 2321(a) (activities performed by personnel in connection with the operation and maintenance of navigation or hydroelectric power generating facilities at Corps of Engineers water resources projects "are to be 'considered as inherently governmental functions and not commercial activities.'"). And, some statutes present very broad definitions. *See*, *e.g.*, 10 U.S.C. § 431(c)(1) ("commercial activities" includes "the acquisition, use, sale, storage and disposal of goods and services"; "entering into employment contracts"; and "establishing corporations, partnerships, and other legal entities").

Perhaps the most well-known use of the term "commercial activities" in a federal statute is in the Foreign Sovereign Immunities Act (the "FSIA"), which endorses the view that foreign states are "not immune" "insofar as their commercial activities are concerned." 28 U.S.C. § 1602; *see also* 28 U.S.C. § 1605(a)(2) (foreign state "shall not be immune . . . in any case . . . in which the action is based upon a commercial activity carried on in the United States by the foreign state . . . ."). The Supreme Court construed the phrase "commercial activities" under the FSIA in a series of important decisions. *See*, *e.g.*, *Saudi Arabia v. Nelson,* 507 U.S. 349 (1993); *Republic of Argentina v. Weltover*, 504 U.S. 607 (1992). According to the Supreme Court, the general thrust of the FSIA "commercial activities" exception is that "a foreign state engages in commercial activity . . . only where it acts 'in the manner of a private player within' the market." *Nelson*, 507 U.S. at 360 (quoting *Weltover*, 504 U.S. at 614). And, the focus is on the "nature," not the "purpose," of the activity. *Weltover*, 504 U.S. at 614; 28 U.S.C. § 1603(d). Recognizing that foreign relations is quite far afield from bankruptcy, the Court still derives from the foregoing that "commercial activities" do not include traditional governmental activities. So, for example, a law enforcement officer performing her job generally is not engaged in a "commercial activity." On the other hand, a private player (such as an individual or company) involved in the private economy and marketplace is engaging in "commercial activity." The Supreme Court's construction of the "commercial activities" phrase seems quite expansive.

Another obvious statutory source that bears on the meaning of "commercial activity" is the Uniform Commercial Code adopted in almost all United States jurisdictions. When lawyers hear the word "commercial," they almost reflexively turn to the Uniform Commercial Code. In Colorado, the Uniform Commercial Code is codified at Title 4, COLO. REV. STAT. The Uniform Commercial Code covers a vast array of topics, including sales of goods and products; leases; negotiable instruments; bank deposits and collections; funds transfers; letters of credit; bulk transfers; investment securities; secured transactions; and more. The Uniform Commercial Code certainly suggests that all of the foregoing are "commercial activities."[69]

2. The Debtor "Engaged in Commercial or Business Activities."

Armed with the foregoing understanding of the phrase "commercial or business activities," the Court returns to bankruptcy and the question: does the Debtor meet the Section 1182(1)(A) eligibility mandate of being a "person engaged in commercial or business activities"? The answer requires the Court to consider both temporal and substantive issues.

a. The Court Must Assess Whether the Debtor Engaged in "Commercial of Business Activities" as of the Petition Date.

In terms of timing, the Court must decide when to make the call: as of the Petition Date or some other time period. During oral argument, the Debtor, the UST, the Subchapter V Trustee, and Sunflower Bank all agreed that the Court must assess whether the Debtor "engaged in commercial or business activities" as of the Petition Date. The Court concurs. Focusing again on the text of Section 1182(1)(A), the phrase "engaged in" (which precedes "commercial or business activities) is a past participle used as an adjective to describe the present state of the noun "person." *See Henson v. Santander Consumer USA Inc.*, 137 S. Ct. 1718, 1722-23 (2017) (construing the phrase "debts 'owed . . . another'" and holding that "past participles like 'owed' are routinely used as adjectives to describe the present state of a thing"); *U.S. v. Barbeito*, 2010 WL 2243878, at *16 (S.D. W. Va. June 3, 2010) (construing the "adjectival phrase" "engaged in" and concluding that "the term 'engaged in' connotes that the thing is 'presently engaged' in the activity.") So, it stands to reason that the Court must look at the then-present state of things as of the Petition Date.

Other parts of the Bankruptcy Code also dictate that the Court should assess the Debtor's status as of the Petition Date. The term "engaged in" frequently is used in the Bankruptcy Code to establish the eligibility (or lack of eligibility) of various persons and entities to file for certain types of bankruptcy protection. Congress generally has utilized the same linguistic formula to express eligibility:

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[69] The Court also has mined the Small Business Act, 15 U.S.C. § 631, searching for the meaning of the phrase "commercial or business activities" or its constituent parts. After all, the title of the Small Business Act is similar to the SBRA. However, other than a broad definition of "small-business concern" (15 U.S.C. § 632(a)(1)), the Court did not find much helpful in the Small Business Act.

> _____ "means" a person or entity "engaged in" [an activity].

For example, Congress provided under Sections 109(b) and (d) that "a railroad" may file for bankruptcy relief under Chapter 11 but not Chapter 7, using the following definition: "[t]he term "railroad" *means* common carrier by railroad *engaged in* the transportation of individuals or property . . . ." 11 U.S.C. § 101(44) (emphasis added). Similarly, Congress stated in Section 109 that a "foreign insurance company, *engaged in* such [insurance] business in the United States" may not be a Chapter 7 debtor. 11 U.S.C. § 109(b)(3) (emphasis added). Also in Section 109(f), Congress provided that a "family farmer" or a "family fisherman" may file for a specialized form of bankruptcy, Chapter 12, following the same eligibility pattern:

> The term "'family farmer" *means* . . . individual . . . *engaged in* a farming operation . . . .
>
> The term "family fisherman" *means* . . . an individual . . . *engaged in* a commercial fishing operation.

11 U.S.C. §§ 101(18) and (19A) (emphasis added).

The phrase "engaged in" also is ubiquitous in other non-eligibility parts of the Bankruptcy Code. *See* 11 U.S.C. § 101(27A) ("The term 'health care business' . . . *means* any public or private entity . . . that is primarily *engaged in* offering to the general public facilities and services [for medical care] . . . ."); 11 U.S.C. § 761(12) ("'foreign futures commission merchant' *means* entity *engaged in* soliciting or accepting orders for the purchase or sale of a foreign future . . . ."). There are even more Bankruptcy Code examples, but the point is this: the Legislative Branch's use of the term "engaged in" in Section 1182(1)(A) was no accident. Instead, the "engaged in" phrase is used throughout the Bankruptcy Code, and it always means the same thing: that a person or entity is presently doing something.[70]

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[70] Stepping outside of Title 11 for just a moment, the Court also observes that Congress has utilized the same type of definitional formula (*i.e.,* _____ "means" a person or entity "engaged in" [an activity]) in many, many scores of federal statutes to regulate all types of *present conduct*. *See*, *e.g.*, 7 U.S.C. § 229b(a)(1) and (2) ("The term 'producer' means any person engaged in the raising and caring for livestock or poultry . . . ."; "The term 'processor' means any person engaged in the business of obtaining livestock or poultry . . . ."); 7 U.S.C. § 6002 ("The term 'grower' means any person engaged in the production and sale of pecans . . . ."); 7 U.S.C. § 6804 ("The term "floral supplier" means a person engaged in acquiring cut flowers or cut greens . . . ."); 15 U.S.C. § 78c(a)(4) ("The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others."); 21 U.S.C. § 453(aa) ("The term 'renderer' means any person engaged in the business of rendering carcasses . . . ."); 33 U.S.C. § 1202 ("'towing vessel' means any commercial vessel engaged in towing another vessel astern, alongside, or by pushing ahead"); 49 U.S.C. § 21101(5) ("'train employee' means an individual engaged in or connected with the movement of a train, including a hostler."); 49 U.S.C. § 30501(3) and (5) ("'insurance carrier' means an individual or entity engaged in the business of underwriting automobile insurance."; "'Junk yard' means an individual or entity engaged in the business of acquiring or owning junk automobiles . . . .").

The Court's conclusion about timing is strongly supported by caselaw construing some of the foregoing parts of the Bankruptcy Code. For example, in *Hileman v. Pittsburgh & Lake Erie Props., Inc. (In re Pittsburgh & Lake Erie Props., Inc.)*, 290 F.3d 516 (3d Cir. 2002), the appellate court considered whether a debtor qualified as a "railroad" for purposes of a "railroad reorganization." As noted above, Section 101(44) of the Bankruptcy Code defines the term "railroad" as a "common carrier by railroad *engaged in* the transportation of individuals or property or owner of trackage facilities . . . ." (emphasis added). The appellate court characterized the Bankruptcy Code's definition of railroad as "using the present-tense 'engaged.'" *Id*. at 519. Since the statute used the present tense:

> . . . . a natural reading . . . confines the scope of application of Subchapter IV to bankruptcy petitioners who are railroads at the time of the petition or thereafter . . . . A chapter 11 bankruptcy "case" raised by an entity that has abandoned being engaged in transporting goods and people does not on the most natural reading of this language concern a railroad, it concerns a former railroad.

Id.

A case construing another definition in the Bankruptcy Code also makes the same point about the linguistic meaning of the term "engaged in": *In re McLawchlin,* 511 B.R. 422 (Bankr. S.D. Tex. 2014). Section 101(18) of the Bankruptcy Code defines "family farmer" as an "individual . . . engaged in a farming operation [who also meets certain debt cap and income origin requirements]." In *McLawchlin* the court considered an eligibility challenge and decided: "To be eligible for relief, an individual must 'be engaged in a farming operation' at the time the Chapter 12 petition is filed." *Id*. at 427. Non-bankruptcy law construing the phrase "engaged in" also is similar. *See P.C. Pfeiffer Co., Inc. v. Ford*, 444 U.S. 69, 84 (1979) (under Longshoremen's and Harbor Workers' Compensation Act, Supreme Court construed the phrase "person engaged in" to mean circumstances "at the time of their injuries"); *Northeast Marine Terminal Co., Inc. v. Caputo*, 432 U.S. 249, 269 (1977) (same); *McGray Constr. Co. v. Director, Office of Workers Comp. Programs*, 181 F.3d 1008, 1014-15 (9th Cir. 1999) (statutory phrase "person engaged in maritime employment" means "engaged" on "this job" which refers to "current employment").

The Court recognizes that there is some contrary authority cited by the Debtor in the Response suggesting that the phrase "engaged in commercial or business activities" should not be "limited" to the Petition Date: *In re Wright*, 2020 WL 2193240 (Bankr. D.S.C. April 27, 2020). In that case, a bankruptcy court baldly stated that "nothing [in the SBRA], or in the language of the definition of a small business debtor, limits application to debtors currently engaged in business or commercial activities." *Id*. at *3. However, the *Wright* court did not actually engage in a statutory interpretation exercise and did not explain its rationale. Instead, it simply quoted a passage from a bankruptcy treatise which itself stated: "The definition of a 'small business debtor' is not

restricted to a person who at the time of filing of the petition is presently engaged in commercial or business activities . . . ." *Id.* (quoting 2 COLLIER ON BANKRUPTCY ¶ 101.51D (16th ed. 2020)). Subsequently, two other bankruptcy courts endorsed the *Wright* court's approach without any additional analysis. *In re Bonert*, 619 B.R. 248, 255-56 (Bankr. C.D. Cal. 2020); *In re Blanchard*, 2020 WL 4032411, at *2 (Bankr. E.D. La. July 16, 2020).

The Court respectfully rejects such aspect of the *Wright-Bonert-Blanchard* line of cases on numerous grounds. First, none of the decisions comes to grips with the statutory language itself, which (as explained above) dictates that "engaged in" means "presently" — as of the Petition Date. Second, the cases also do not examine the grammar (*i.e.,* "engaged in" is a past participle used as an adjective to describe the present state of the noun "person") and do not account for analogous case law precedent focusing on similar language either. Third, the sole support cited in *Wright,* the bankruptcy treatise COLLIER ON BANKRUPTCY, subsequently was revised to remove the very passage relied upon by the *Wright* court. In other words, the treatise authors changed their minds and no longer argue against a temporal restriction as of the Petition Date. Fourth, more persuasive subsequent case law construes the "engaged in" phrase as applying to the circumstances as of the Petition Date. *In re Johnson*, 2021 WL 825156, at *6 (Bankr. N.D. Tex. Mar. 1, 2021) ("the 'engaged in' inquiry is inherently contemporary in focus"); *In re Thurmon*, 2020 WL 7249555, at *3 (Bankr. W.D. Mo. Dec. 8, 2020) (construing the SBRA and deciding that "[t]he plain meaning of "engaged in" means to be actively and currently involved."). And, finally, even the Debtor shifted position in closing argument and conceded that whether the Debtor was "engaged in commercial or business activities" must be determined as of the Petition Date.

Although the Court must assess whether the Debtor was "engaged in commercial or business activity" as of the Petition Date, focusing only on the exact nano-second the Petition was filed is a bit too narrow. For example, perhaps the Debtor did no work on the Petition Date itself. So, in considering whether the Debtor was engaged in "commercial or business activity" as of the Petition Date, the Court deems relevant the circumstances immediately preceding and subsequent to the Petition Date as well as the Debtor's conduct and intent.

b. <u>The Debtor "Engaged in Commercial or Business Activities" as of the Petition Date</u>.

Having decided the temporal issue, the Court must determine whether, under the facts and circumstances in this particular Subchapter V case, the Debtor "was engaged in commercial or business activity" as of the Petition Date. The Court employs a "totality of the circumstances" test to make the call. *Cf. Watford v. Fed. Land Bank of Columbia (In re Watford)*, 898 F.2d 1525, 1528 (11th Cir. 1990) (adopting "totality the

circumstances" to decide whether the debtor was "engaged in a farming operation" as of the petition date).[71]

Because Hailco "was forced to cease operations and surrender its assets to its secured lender" prior to the Petition Date, the Court's decision is a difficult one. However, under the very broad scope of the phrase "commercial or business activities," the Court concludes that the Debtor was engaged in the following categories of "commercial or business activities" as of the Petition Date: (1) "commercial or business activities" pertaining to JMI; (2) "commercial or business activities" pertaining to Hailco; and (3) "commercial or business activities" pertaining to CCIG.

With respect to JMI, the Debtor has directly owned all of the membership interests in the entity since 2012. He owned such equity as of the Petition Date and afterward. Non-passive ownership is a form of "commercial or business activity." *See* 11 U.S.C. 1182(1)(A) (referring to the "business of owning"); *see also* Nicholas Karambelas, LIMITED LIABILITY COMPANIES: LAW, PRACTICE, AND FORMS ¶ 1.1 (Thompson Reuters Supp. 2021) (limited liability company "enables the entrepreneur to do business through a legal entity that maximizes flexibility in internal operations and minimizes . . . legal artifices that hamper the process of making business decisions based primarily on financial and commercial considerations"). During all relevant times, the Debtor also acted as the only manager of JMI. Managing or directing the operations of a limited liability company is a "commercial or business activity." The Debtor formed and managed JMI as a mechanism to obtain income including through investments. During recent years, JMI has received income from the Fairmount Cemetery for the Debtor's service on its Board of Directors and also through management fees for Hailco (albeit that JMI suffered net losses). JMI also owns 30 percent of Hailco. JMI has not been dissolved under COLO. REV. STAT. §§ 7-80-801 *et seq*. The Debtor confirmed his intention to continue operating JMI. And, recently, JMI entered into a "Business Consulting Agreement" with SkyHelm. The Debtor signed the new contract as Managing Member of JMI. All the foregoing activities undertaken by the Debtor were performed in the private sector and did not constitute governmental activity. Thus, the Debtor's actions regarding JMI (as of the Petition Date as well as shortly before and after), satisfy the Section 1182(1)(A) requirement that the Debtor was "engaged in commercial or business activities."

With respect to Hailco, the company was engaged in the sale of automotive hail repair services to the general public. The Debtor has indirectly owned a minority interest in the entity (through JMI) for several years. He indirectly owned such equity as

[71] Several of the parties also have argued that the Court should decide what Congress had in mind and consider the SBRA legislative history. However, the Court should not decide "what the legislature meant . . . [but] only what the statute means." Oliver Wendell Holmes, *The Theory of Legal Interpretation*, 12 HARV. L. REV. 417, 419 (1899). In fact, the exercise of trying to divine intent from legislative statements (whether from floor speeches, debates, or committee reports) is a sort of fiction. *See* READING LAW 394 ("The use of the term *legislative intent* encourages this search for the nonexistent.") But, in this case, even if the Court wanted to seek fiction, it would be even more impossible because there is no helpful legislative history really explaining Section 1182(1)(A). Instead, the legislative history is essentially generic.

of the Petition Date and afterward. Such non-passive ownership, albeit indirect and non-majority, constitutes "commercial or business activity." Hailco has not been dissolved under COLO. REV. STAT. §§ 7-80-801 *et seq*. During all relevant times, the Debtor also has acted as one of the managers of Hailco. He engaged in the management and operation of Hailco with the intent to earn income, even though the entity ultimately failed. Further, although Hailco was "forced to cease operations and surrender its assets to its secured lender" shortly before the Petition Date and the Debtor stopped working there as an employee, the Debtor has continued both before and after the Petition Date to perform some activities to "wind down" Hailco. Toward that end, the Court notes that as a manager of Hailco, the Debtor owes the company duties, including the duty to "[a]ccount to the limited liability company and hold as trustee for it any property, profit, or benefit derived by the member or manager in the conduct or winding up of the limited liability company business . . . ." COLO. REV. STAT. § 7-80-404(1)(a). And, as a manager of Hailco, the Debtor has the power to bind Hailco as its agent. COLO. REV. STAT. § 7-80-405(1)(b). If Hailco is dissolved, the Debtor may also have additional obligations. COLO. REV. STAT. § 7-80-803. In any event, both before and after the Petition Date, the Debtor has been engaged in the Wind Down Work, including: interacting with lenders and a landlord; helping cleanup and turnover lease premises; assisting with payroll; dealing with tax accountants and tax issues; organizing and storing business records; and performing some other work. All the foregoing activities undertaken by the Debtor were performed in the private sector and do not constitute governmental activity. Although there is not any intention that Hailco continue active operations in the future, the foregoing Wind Down Work as well as the Debtor's other actions qualify as "commercial or business activities" of the Debtor within the broad and expansive meaning of the term under Section 1182(1)(A) as of the Petition Date.

Since Hailco stopped operations about a month before the Debtor's bankruptcy filing, the Court's call is close. There is some compelling authority which gives the Court substantial pause: *Thurmon*, 2020 WL 7249555; and *Johnson*, 2021 WL 825156. In *Thurmon*, the individual debtors owned a majority interest in a limited liability company which operated two pharmacies. About three months before they filed for bankruptcy, the debtors "closed the pharmacies and sold almost all of the business assets." By the time of the debtors' bankruptcy filing, the entities "had no employees, no customers, no vendors and no intent to resume business activities." *Thurmon*, 2020 WL 7249555, at *1-2. But, the limited liability company remained in good standing. The *Thurmon* court decided that the debtors were not eligible under Subchapter V because they "were not as a matter of fact or law 'engaged in commercial or business activities' on the day they filed bankruptcy." *Id*. at *5. That all sounds quite right and very similar to this case. But similar is not the same. Ultimately, The Court distinguishes *Thurmon* because of a different factual record. In this case, unlike in *Thurmon*, the Debtor had two limited liability companies. JMI did not "cease business" and is still operating and receiving income. With respect to Hailco, even though the entity stopped its active business operations, the Debtor presented a record of Wind Down Work in which the Debtor had engaged in before and after the bankruptcy filing (*i.e.*, as of the Petition Date). Each category of Wind Down Work itself constitutes "commercial or business

activities" in the broad sense: communicating with lenders and a landlord; helping cleanup and turnover lease premises; assisting with payroll; dealing with tax accountants and tax issues; organizing and storing business records; and performing some other work. Section 1182(1)(A) speaks only to whether the Debtor was "engaged in commercial or business activity" as of the Petition Date — not whether the Debtor was making a profit, actively operating, or intending to operate in the future. So, the facts lead this Court in a different direction than the *Thurmon* decision, but just barely.

Regarding the Debtor's involvement with Hailco, the Court also carefully considered the opinion in *Johnson*, 2021 WL 825156. In that case, two individual debtors filed for Chapter 7 liquidation on May 22, 2019. They later sought to convert from Chapter 7 liquidation to Chapter 11 Subchapter V reorganization. One of the debtors asserted that he "engaged in commercial or business activities" based on the his "*prior* ownership and management of the Defunct Companies." *Id*. at *5 (emphasis and capitalized, defined term in original). That debtor owned and managed seven entities (mostly limited liability companies) prior to his bankruptcy. Two of the companies went out of "existence" in 2017; four of the entities went out of "existence" in 2018; and one of the companies ended its "existence" in 2019 about four months before the start of the bankruptcy case. *Id*. at *2. The *Johnson* court characterized all the companies as "Defunct" and held:

> [T]he evidence is clear that each of the Defunct Companies had ceased all commercial and business activities prior to the Petition Date and that [the debtor] was not occupied with or otherwise busy in — *i.e.* 'engaged in' — any commercial or business activities with respect to the Defunct Companies.

Id. at *7. Thus, the *Johnson* court found that the debtor was not eligible under Subchapter V. The forgoing scenario is similar to the current dispute – again, similar but not the same. From the text of the decision, the Court guesses that the *Johnson* Defunct Companies were dissolved and no longer existed as of the date when the debtor's case was filed. After all, the court referred to the "disclosed periods of existence" for each of the companies. *Id*. at 2. Six out of the seven entities no longer "existed" years before the bankruptcy filing. And, there was no evidence that the debtor was "occupied with or otherwise busy in" the Defunct Companies. This dispute is distinguishable because, unlike in *Johnson*, the Debtor's wholly-owned company, JMI, did not "cease business" and is still operating and receiving income. And, the Debtor presented a record of Wind Down Work in which the Debtor had engaged before and after the bankruptcy filing, work to which he had devoted about 12 hours a month. Each category of Wind Down Work itself constitutes "commercial or business activities" in the broad sense. So, the facts point this Court to a different place than the *Johnson* decision. Again, just barely.

Moving on to a final category of "commercial or business activity" – with respect to CCIG, the Debtor started working at CCIG before the Petition Date as a "Commercial Insurance Producer." That role has continued post-petition too. As a "Commercial

Insurance Producer," the Debtor is a salaried employee who sells commercial insurance products. The Debtor does not own any equity in CCIG. Instead, he receives a monthly salary of $11,250.00. The Debtor's involvement with CCIG is for the purpose of obtaining income. Under the exceptionally broad scope of the Section 1182(1)(A) "commercial or business activities" requirement, the Court concludes that the Debtor's work as a wage earner with CCIG constitutes "commercial or business activities." After all, his role is selling a product in the private marketplace in order to make money for himself and his employer. That is what "commercial activity" and "business activity" means. *See* WEBSTER'S THIRD NEW INT'L DICTIONARY 302 and 456 (G. & C. Merriam Co. 1968) ("commerce" means "the exchange or buying and selling of commodities"; business" means "usu. commercial or mercantile activity customarily engaged as a means of livelihood."); AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 252 and 370 (Houghton Mifflin Harcourt 5th ed. 2011) ("commercial" means "of or relating to commerce"; "commerce" means "the buying and selling of goods"; "business" means "the activity of buying and selling commodities, products, or services" or "a specific occupation or pursuit."); Bryan A. Garner, BLACK'S LAW DICTIONARY 239 (Thompson Reuters 10th Ed. 2014) ("business" means "a commercial enterprise carried out for profit; a particular occupation or employment habitually engaged in for livelihood or gain").[72]

The Court realizes that its legal conclusion regarding the Debtor's work for CCIG suggests that virtually all private sector wage earners may be considered as "engaged in commercial or business activities." So be it. In a very real sense, even employees flipping burgers at fast food restaurants are "engaged in commercial or business activities" as a part of our grand American economy in that they are helping produce and sell a product. There is no reason that "commercial or business activities" are somehow reserved only for business titans, company owners, or management. Every non-governmental worker has their role to play in private sector commerce and business.

Notwithstanding the seemingly radical nature of the Court's foregoing legal conclusion, that does not mean that every private sector wage earner is eligible for relief under Subchapter V of the Bankruptcy Code. Not at all. There is still another hurdle under Section 1182(1)(A) which is difficult to meet and which severely limits the use of Subchapter V for individuals: "not less than 50%" of the Debtor's "aggregate noncontingent liquidated secured and unsecured debts" must have arisen from "the commercial or business activities of the [D]ebtor." The typical hamburger artist, earning just minimum wage, will almost never be putting his own capital at risk and incurring debts which arise from his work. So, Subchapter V will not be for everyone.

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[72] There is contrary authority: *Johnson*, 2021 WL 825156. In that case, a debtor served as an officer and employee of an entity which he also managed. *Id.* at 3. However, he had no ownership interest and was a "W-2 employee." The *Johnson* court decided that the debtor was "nothing more than an employee of El Reno with heightened obligations to the company on account of his role as officer. As such [the debtor] does not qualify as a small business debtor under [the "commercial or business activities" part of] Section 101(51D)." *Id*. at *8. The Court respectfully disagrees with the foregoing holding on the basis that employees can engage in "commercial or business activities" in the broad sense of Section 1182(1)(A). Furthermore, the statute does not impose any additional requirement of ownership or control of an entity.

3. Most of the Debtor's Debts Arose from His "Commercial or Business Activities."

The last Section 1182(1)(A) requirement is that "not less than 50 percent [of the Debtor's debts] . . . arose from the commercial or business activities of the debtor . . . ." Accepting the Debtor's identification of $7,396,750.09 in aggregate debt on his Schedules, half is $3,698,375.05. So, the statutory question becomes whether $3,698,375.05 or more of the Debtor's aggregate debt "arose from the commercial or business activities of the debtor"? Neither the UST nor Sunflower Bank actively contested this Section 1182(1)(A) issue. However, the Court scrutinizes the element anyway.

The Court already has decided that the Debtor "engaged in" the following "commercial or business activities" as of the Petition Date: (1) "commercial or business activities" pertaining to JMI; (2) "commercial or business activities" pertaining to Hailco; and (3) "commercial or business activities" pertaining to CCIG. But there is an important "the" in the Section 1182(1)(A) statutory text. More than half of the Debtor's debts must have arisen from "*the* commercial or business activities of the Debtor." So, the debt must be tied to the particular type of commercial or business activities the Debtor engaged in.

One of the categories of the Debtor's "commercial or business activities" will clearly not support Subchapter V eligibility: his work for CCIG. The Debtor started working as a salaried employee of CCIG just shortly before the Petition Date. And, none of his debts "arose from" his "commercial or business activities" with CCIG. He did have any skin in the game.

But the Debtor put himself on the line big-time for Hailco, through JMI. The vast majority of his debts arose from guarantees he provided to support loans for Hailco. The prime example is Sunflower Bank. On August 15, 2018, the Debtor executed an "Unconditional Guarantee" in favor of Sunflower Bank unconditionally guaranteeing payment to Sunflower Bank of up to $5,000,000 loaned by Sunflower Bank to Hailco. Sunflower Bank claims that the Debtor owes it $4,364,744.99. There are seven other creditors who also have claims based upon the Debtor's guarantee of Hailco debt. Altogether, the claims against the Debtor premised on the Debtor's guarantees of Hailco debt total $6,388,756.03. The total claims against the Debtor are $7,396,750.09. Thus, the Hailco debt guarantee claims against the Debtor tally to about 86% of the aggregate claims pool — far more than the 50% required by Section 1182(1)(A).

There is only one loose end left: did that 86% of the Debtor's debt (based on the Hailco guarantee claims) arise from "the commercial or business activities of the debtor"? For the debt to have "ar[isen] from the commercial or business activities of the debtor," the debt must be directly and substantially connected to the "commercial or business activities" of the debtor. *See Woods,* 743 F.3d at 698 (in Chapter 12 context, "a debt "for" a principal residence "arises out of" a farming operation only if the debt is

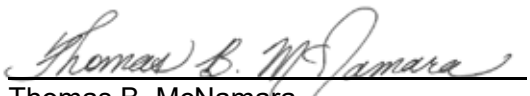
directly and substantially connected to the farming operation"; using dictionary definitions of "arise" as meaning "to originate; to stem (from)" or "to result from"). In this context, the Court may also look back in time before the Petition Date to ascertain whether the debt arose from the same general types or categories of "commercial or business activity" which the Debtor was engaged in as of the Petition Date. After all, debts do not arise on the exact date a bankruptcy petition is filed. For example, the Sunflower Bank claim is based upon a guarantee made two years before the Petition Date. The Court determines that the Debtor's debt based on the Hailco guarantee claims "arose from" the Debtor's "commercial or business activities" with both Hailco and JMI (which owned Hailco). The Court's conclusion is almost self-evident. No one would put millions of dollars of personal guarantees on the line for a company unless it was to advance the guarantor's own commercial and business interests. Put another way, the Debtor must have thought Hailco would succeed and the Debtor would receive a return (through his indirect equity ownership as well as income for employment and management) — or he would not have put up the guarantees. The guarantees also allowed Hailco to obtain financing to operate. Making financial guarantees for a company in which the Debtor has an indirect equity interest is itself a "commercial or business activity." And, of course, the Debtor (as a manager of both JMI and Hailco and a former employee of Hailco) was engaged in all the other types of "commercial or business activities" pertaining to JMI and Hailco noted above, plus more, because the guarantees were given by the Debtor when Hailco was still operating. Based on the foregoing, as well as the failure of the UST and Sunflower Bank to really contest the point, the Court finds that the Debtor met the last Section 1182(1)(A) hurdle because far more than 50% of his debts "arose from the commercial or business activities of the debtor."

VI. Conclusion.

This dispute has involved a number of novel and challenging legal issues in the context of new legislation. The Court appreciates the able advocacy of counsel for all the interested parties. However, in the end and for the reasons set forth above, the Court concludes that the Debtor has met his obligation to establish his eligibility as a small business debtor under Section 1182(1)(A) and the SBRA because he is a person who was engaged in commercial or business activities (as of the Petition Date) whose debts are less than $7,500,000 and more than half of which arose from the commercial or business activities of the Debtor. Accordingly, the Court:

DENIES and OVERRULES the Eligibility Objection. The Debtor may proceed toward confirmation of his Plan.

DATED this 15th day of April, 2021. BY THE COURT:



Thomas B. McNamara,
United States Bankruptcy Judge

Faculty

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

Hon. John T. Gregg is a U.S. Bankruptcy Judge for the Western District of Michigan in Grand Rapids, appointed on July 17, 2014. Previously, he was a partner with the law firm of Barnes & Thornburg LLP, where he focused on corporate restructuring, bankruptcy and other insolvency matters. Judge Gregg is a frequent writer and speaker on bankruptcy and other commercial issues. He has written and co-edited numerous treatises and articles for various publications, including *Collier Guide to Chapter 11*, published by LexisNexis; *Strategies for Secured Creditors in Workouts and Foreclosures,* published by ALI-ABA; *Issues for Suppliers and Customers of Financially Troubled Auto Suppliers* and *Interrupted! Understanding Bankruptcy's Effects on Manufacturing Supply Chains*, both published by ABI; *Michigan Security Interests in Personal Property*, published by the Institute for Continuing Legal Education; *Handling Consumer and Small Business Bankruptcies in Michigan*, published by the Institute for Continuing Legal Education; and *Receiverships in Michigan,* published by the Institute for Continuing Legal Education. Judge Gregg received his B.A. in 1996 from the University of Michigan and his J.D. in 2002 from DePaul University College of Law.

Hon. Bruce A. Harwood is Chief U.S. Bankruptcy Judge for the District of New Hampshire in Concord, appointed to the bench in March 2013. He also serves on the First Circuit's Bankruptcy Appellate Panel. Prior to his appointment to the bench, Judge Harwood chaired the Bankruptcy, Insolvency and Creditors' Rights Group at Sheehan Phinney Bass + Green in Manchester, N.H., representing business debtors, asset-purchasers, secured and unsecured creditors, creditors' committees, trustees in bankruptcy, and insurance and banking regulators in connection with the rehabilitation and liquidation of insolvent insurers and trust companies. He was a chapter 7 panel trustee in the District of New Hampshire and mediated disputes arising in debtor/creditor relations. Judge Harwood serves on ABI's Board of Directors on its Communication, Information and Technology Committee. He served as co-chair of ABI's Commercial Fraud Committee, as program co-chair of (and presently as judicial advisor to) ABI's Northeast Bankruptcy Conference; and as Northeast Regional Chair of the ABI Endowment Fund's Development Committee. He also served on ABI's Civility Task Force. Judge Harwood is a Fellow in the American College of Bankruptcy and was consistently recognized in the bankruptcy law section of *The Best Lawyers in America*, in *New England SuperLawyers* and by

Chambers USA. He received his B.A. from Northwestern University and his J.D. from Washington University School of Law.

Hon. Barbara J. Houser is a U.S. Bankruptcy Judge for the Northern District of Texas in Dallas and ABI's President. She previously was with Locke, Purnell, Boren, Laney & Neely in Dallas and became a shareholder there in 1985. In 1988, she joined Sheinfeld, Maley & Kay, P.C. as the shareholder-in-charge of the Dallas office and remained there until she was sworn in as a U.S. Bankruptcy Judge in 2000. While at Sheinfeld, Judge Houser led the firm's representation of clients in a variety of significant national chapter 11 cases. She lectures and publishes frequently, is a past chairman of the Dallas Bar Association's Committee on Bankruptcy and Corporate Reorganization, is a member of the Dallas, Texas and American Bar Associations, and is a Fellow of the Texas and American Bar Foundations. Judge Houser served as a contributing author to Collier on Bankruptcy for many years and taught creditors' rights as a visiting professor at the SMU Dedman School of Law. She was elected a Fellow of the American College of Bankruptcy in 1994, and in 1996, she was elected a conferee of the National Bankruptcy Conference. In 1998, the National Law Journal named Judge Houser as one of the 50 most influential women lawyers in America. After becoming a bankruptcy judge, she joined the National Conference of Bankruptcy Judges and served as its president from 2009-10. She received the Distinguished Alumni Award for Judicial Service from the SMU Dedman School of Law in February, 2011, the William L. Norton Jr., Judicial Excellence Award in October 2014, and the Distinguished Service Award from the Alliance of Bankruptcy Inns of the American Inns of Court in October 2016. Judge Houser currently serves as a member of the executive board of the SMU Dedman School of Law, and in March 2017, Chief Justice John Roberts appointed her to serve as a member of the board of directors of the Federal Judicial Center, the education and research arm of the Third Branch. In June 2017, she was appointed to serve as the leader of a five-federal-judge mediation team in the Title III proceedings under PROMESA for the Commonwealth of Puerto Rico and four related governmental instrumentalities. Judge Houser received her undergraduate degree with high distinction from the University of Nebraska and her J.D. from Southern Methodist University Law School, where she was editor of its law review.

Hon. Laurel M. Isicoff is Chief Judge for the U.S. Bankruptcy Court for the Southern District of Florida in Miami, initially appointed on Feb. 13, 2006, and named chief judge on Oct. 1, 2016. She is the president of the National Conference of Bankruptcy Judges, and is also a member of ABI's Board of Directors. Judge Isicoff is a member of the *Pro Bono* Committee of the American College of Bankruptcy, as well as chair of its Judicial Outreach Committee. She also currently serves as judicial chair of the *Pro Bono* Committee of the Florida Bar's Business Law Section and is a member of the Florida Bar's Standing Committee on *Pro Bono*. Prior to becoming a judge, Judge Isicoff specialized in commercial bankruptcy, foreclosure and workout matters both as a transactional attorney and litigator for 14 years with the law firm of Kozyak Tropin & Throckmorton, after practicing for eightyears with Squire, Sanders & Dempsey, now known as Squire Patton Boggs. In private practice, she also developed a specialty in SEC receiverships involving Ponzi schemes. Following law school, Judge Isicoff clerked for Hon. Daniel S. Pearson at the Florida Third District Court of Appeals before entering private practice. She is a past president of the Bankruptcy Bar Association (BBA) of the Southern District of Florida, and, until she took the bench, chaired its *Pro Bono* Task Force. Judge Isicoff speaks extensively on bankruptcy around the country, and is committed to increasing *pro bono* service, diversity in the bankruptcy community and financial literacy. She received her J.D. from the University of Miami School of Law in 1982.

Hon. Stacey L. Meisel is a U.S. Bankruptcy Judge for the District of New Jersey in Newark and is the first African-American selected for this position in New Jersey. Before joining the bench, she was a founding member of Becker Meisel LLC and co-chaired its bankruptcy, insolvency and creditors' rights practice. Prior to her appointment, Judge Meisel served on the New Jersey Panel of Bankruptcy Trustees and thrice served on the committee that recommends candidates to the Third Circuit for New Jersey bankruptcy judgeship vacancies. She also served on the New Jersey Court Registry of Mediators and the Lawyers Advisory Committee to the Board of Judges of the U.S. Bankruptcy Court for the District of New Jersey. Judge Meisel previously served as trustee to the Association of the Federal Bar of New Jersey, on the ABI Advisory Board for the Mid-Atlantic Bankruptcy Workshop, and as chair of the 2011 Workshop Attendance Committee. She helped launch the New Jersey Bankruptcy Lawyers Foundation, volunteered with Volunteer Lawyers for Justice and served on the board of directors for Legal Momentum – The Women's Legal Defense and Education Fund. Judge Meisel is a co-author of the *Consumer Bankruptcy Manual* and the *Consumer Bankruptcy Handbook*, both Thomson Reuters publications. She is also serving a three-year term on the National Conference of Bankruptcy Judges' Rules Committee, and she serves on the National Association of Women Judges' Color of Justice Program Committee and the U.S. District Court, District of New Jersey Committee on Court Security. Judge Meisel received her Bachelor's degree from Rutgers The State University of New Jersey and her J.D. from Villanova University School of Law.

Hon. Cynthia A. Norton is a U.S. Bankruptcy Judge for the Western District of Missouri in Kansas City, sworn in on Feb. 1, 2013. Prior to her appointment, she clerked for Hon. John E. Rees of the Kansas Court of Appeals and Hon. James A. Pusateri, U.S. Bankruptcy Judge, and was a partner at Lewis Rice & Fingersh in Kansas City before establishing her own law firm in 1995. As a member of Grimes & Rebein, Judge Norton practiced in bankruptcy and related fields in Kansas and Missouri until being sworn in as a bankruptcy judge in the Western District of Missouri. She is the recipient of the Michael R. Roser Excellence in Bankruptcy Award and the Robert L. Gernon Award for Outstanding Contribution to CLE, as well as a Fellow in the American College of Bankruptcy. Judge Norton has authored numerous articles and seminar papers, and spoken at conferences all around the country. She received her B.A. in French and art history Phi Beta Kappa and *summa cum laude* from Kansas University and her J.D. from the Kansas University Law School, where she was associate editor of its law review.

William J. Rochelle, III is ABI's Editor-at-Large and resides in Santa Fe, N.M. Previously, he published for Bloomberg from 2007-15. Prior to his second career in journalism, Mr. Rochelle practiced bankruptcy law for 35 years, including 17 years as a partner in the New York office of Fulbright & Jaworski LLP. In addition to writing, he travels the country for ABI, speaking to bar groups and professional organizations on hot topics in the turnaround community and trends in consumer bankruptcies. Mr. Rochelle earned his undergraduate and law degrees from Columbia University, where he was a Harlan Fiske Stone Scholar.

Hon. Christopher S. Sontchi is Chief U.S. Bankruptcy Judge for the District of Delaware in Wilmington, initially appointed in 2006, and is a frequent speaker in the U.S. and abroad on issues relating to corporate reorganizations. He also is a Lecturer in Law at The University of Chicago Law School and teaches corporate bankruptcy to international judges through the auspices of the World Bank and INSOL International. Judge Sontchi is a member of the International Insolvency Institute, Judicial

Insolvency Network, National Conference of Bankruptcy Judges, ABI and INSOL International. He was recently appointed to the International Advisory Council of the Singapore Global Restructuring Initiative and the Founders' Committee of The University of Chicago Law School's Center on Law and Finance. Judge Sontchi has published articles on creditors' committees, valuation, asset sales and safe harbors. Prior to his appointment, he was in private practice, representing a wide variety of nationally based enterprises with diverse interests in most of the larger chapter 11 reorganization proceedings filed in Delaware. Judge Sontchi served on the ABI Commission to Study the Reform of Chapter 11's Financial Contracts, Derivatives and Safe Harbors Committee and testified on safe harbors for financial contracts before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the House Committee on the Judiciary. Following law school, Judge Sontchi clerked for Hon. Joseph T. Walsh in the Delaware Supreme Court. He received his B.A. Phi Beta Kappa with distinction in political science from the University of North Carolina at Chapel Hill and his J.D. from the University of Chicago Law School.