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YOU BE THE RACE DIRECTOR

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TABLE OF CONTENTS

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The Good Lawyer & the Gambler

By Cynthia A. Norton, W.D. MO

Pre-pandemic, you travel to an outer division once a month to hold court there. The bankruptcy bar is small but close-knit, and you generally enjoy going because the lawyers care for their clients and try to do a good job.

But this month, while preparing, you notice something disturbing on your docket. The UST has filed two motions: a motion to dismiss a Debtor's chapter 7 case for bad faith and abuse under § 707(b) and a motion to compel the Debtor's lawyer to disgorge 100% of his otherwise modest fee of $1200 pursuant to § 329 or in the alternative for sanction under § 707(b)(4)(B) for the failure to perform a reasonable investigation. The UST alleges that the Debtor has gambling income; the Debtor advised his lawyer about the gambling; and the lawyer did not disclose it either on the Schedules I/J or the Statement of Financial Affairs.

You are troubled. This lawyer has practiced in the bankruptcy community for 30+ years and has never been in trouble before you. He does lots of pro bono and reduced fee consumer work – mostly not very sophisticated – but he cares for his clients and has always done a good job. But the case has been on file for nine months; the UST has taken a 2004 exam in which the Debtor admits to having gambled, both pre- and post-petition. Yet, although the lawyer has filed an amended SOFA to reflect the gambling income, he didn't file the amendment until after the UST filed his motions and only on the eve of the hearing. And no other schedules or statements have been amended.

Then, you notice another troubling issue: the petition states that the Debtor has primarily consumer debts. But when you examine the schedules more closely, you don't believe that could possibly be correct. The majority of the Debtor's debts, including his mortgage, are from his auto body business; in fact, the Debtor lives in an apartment just above his shop.

At the hearing, you question the UST closely; why should the lawyer be compelled to disgorge the entire fee as excessive under § 329? The UST is adamant that the lawyer has helped the client to lie. But you don't think the exam transcript is that clear about whether the debtor actually told his lawyer and the Debtor isn't even present at the hearing. The Debtor's lawyer, on the other hand, is indignant; he insists he asked the Debtor about gambling income and the Debtor denied it. But rather than address the merits of both motions, the lawyer attacks the UST attorney personally, accusing the UST of not returning his calls and not trying to work with him. He insists he has done nothing wrong.

What do you do?

Authorities to Consider:

- ***Dismissal for Cause:*** Under **§ 707(a)**, the court may dismiss a case under this chapter only after notice and a hearing and only for cause . . .

- ***Burden of Proof; What Constitutes "Cause":*** The burden of proof rests on the moving party, to prove cause. *In re Chovev*, 559 B.R. 339, 343 (Bankr. E.D.N.Y. 2016) (citation omitted). "The determination of what constitutes 'cause' to dismiss an individual debtor's chapter 7 case is left to the discretion of the court." *Id.* at 343-44.

- ***Dismissal for Abuse of Individual with "primarily consumer debts":*** **§ 707(b)(1)** provides that the after notice and a hearing, a court may dismiss a case filed by an individual whose debts are primarily consumer debts if granting relief would be an abuse of the code. **Section 101(8)** defines "consumer debt" as "debt incurred by an individual primarily for a personal, family or household purpose.'" *In re Lapke*, 428 B.R. 839, 843 (B.A.P. 8th Cir. 2010). "Consumer debt can be both secured and unsecured. *In re Cox*, 315 B.R. 850, 855 (B.A.P. 8th Cir. 2004) (citing *Zolg v. Kelly (In re Kelly),* 841 F.2d 908, 912 (9th Cir.1988)).

- ***When Abuse Presumed***: **§ 707(b)(2)(A)(i)** provides that the court presumes abuse exists when the debtor's current monthly income exceeds certain amounts.

- ***Rebuttal of the Presumption; Dismissal for Bad Faith:*** **§ 707(b)(2)** provides that when abuse is presumed, the debtor may rebut the presumption by showing special circumstances. When the presumption of abuse does not arise, however, the case may still be dismissed upon a showing that the case was filed in bad faith under **§ 707(b)(3)(A).**

- ***Bad Faith***: Caution should be exercised before concluding that bad faith is present. *In re Baum*, 386 B.R. 649, 653 (Bankr. N.D. Ohio 2008). "'Dismissal based on lack of good faith ... should be confined carefully and is generally utilized only in those egregious cases that entail concealed or misrepresented assets and/or sources of income, and excessive and continued expenditures, lavish lifestyle, and intention to avoid a large single debt based on conduct akin to fraud, misconduct, or gross negligence.'" *In re Baum*, 386 B.R. at 653 (citing *Industrial Ins. Svcs., Inc. v. Zick (In re Zick*), 931 F.2d 1124, 1129 (6th Cir. 1991)). "The standard is thus a flexible one, but a high one." *In re Baum*, 386 B.R. at 653.

- ***Right to Amend Schedules***: "**Rule 1009(a)** provides that a debtor may amend, at any time, as a matter of course before the case is closed." *In re Ladd*, 450 F.3d 751, 755 (8th Cir. 2006).

- ***Disgorgement When Compensation Exceeds the Reasonable Value of the Services:*** **§ 329** "authorizes the court to order the return of any payment made to an attorney for a debtor for services rendered in connection with a bankruptcy case '[i]f such compensation exceeds the reasonable value of any such services....'" *In re Triepke*, No. 09-21855-DRD-7, 2012 WL 1229524, at *2 (Bankr. W.D. Mo. Apr. 12, 2012). "The test under § 329 measures *reasonable value of the services* provided by the attorney." *In re Redding*, 247 B.R. 474, 478 (B.A.P. 8th Cir. 2000). "Because § 329 is aimed solely at preventing

overreaching by a debtor's attorney ... a court's consideration of whether to order disgorgement of fees under § 329(b) is limited to the comparison of the amount of compensation received by the attorney with the reasonable value of the services performed." *Id*.

- ***Burden of Proof on Reasonableness of Fees:*** The burden of proof rests on the attorney to prove that the agreed compensation was reasonable. *In re Mahendra,* 131 F.3d 750, 757 (8th Cir.1997).

- ***Duty to Investigate; Attorney's Conduct Must Be Objectively Reasonable:*** **§ 707(b)(4)(B)** authorizes the Court to assess a civil penalty against a debtor's attorney, payable to the Trustee or UST, if the Court, on its own motion or the motion of a party in interest, and in accordance with Rule 9011 procedures, finds that the attorney has violated Rule 9011. The established standard for imposing sanctions is an objective determination of whether a party's conduct was reasonable under the circumstances.

- ***ABA Model Rule 1.7(a)(2):*** A lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if: … there is a significant risk that the representation of one or more clients will be materially limited … by a personal interest of the lawyer.

The Purple Unicorn

Are Unimpaired Unsecured Creditors Entitled to Post-Petition Interest?

Hon. Christopher S. Sontchi, USBC (D. Del.)

FACTUAL BACKGROUND

The corporate debtors in this case have a complicated capital structure with two silos of debtors, each with their own, independent debt. The Debtors have proposed a plan where the unsecured creditors of Silo #1 will inject new money and acquire the assets of Silo #2. In the process, the secured and unsecured creditors of Silo #2 will be paid "in full," i.e., leaving the creditors of Silo #2 unimpaired.

The capital structure of Silo #2 consists of two holding companies that ultimately own a valuable, non-debtor utility company. ABC Holding Corp. is a holding company with secured and unsecured debt. It owns 100% of ABC Intermediate Holding Company, which is a holding company with its own secured and unsecured debt. ABC Intermediate Holdings, in turn, owns a majority stake in the non-debtor utility company.

Under the proposed plan, the unsecured noteholders of ABC Intermediate Holding Company (the "Noteholders") are to receive payment of all principal, interest, and fees due at the petition date, **plus post-petition interest at the federal judgment rate**. Importantly, the unsecured creditors of ABC Holding Company's parent are also receiving the same treatment. The Debtors assert that the Noteholders are unimpaired and, thus, are deemed to have accepted the plan. The Noteholders object, arguing that ABC Holding Corp. is solvent as its parent's creditors are receiving a distribution. Thus, for the Noteholders to be unimpaired, the must receive payment of all principal, interest, and fees due at the petition date, **plus post-petition interest at the contract rate.**

REQUESTED RELIEF

To resolve the dispute, the Debtors filed a partial objection to the Noteholders' proof of claim. In the Objection, the Debtors argue that, under section 502(b)(2) of the Bankruptcy Code, the Noteholders' claim for post-petition interest must be disallowed as "unmatured interest." At most, the Debtors argue, the Noteholders' claim for post-petition interest is limited under section 726(a)(5), made applicable by section 1129(a)(7)(A)(ii), to "payment of interest at the legal rate," which the Debtors claim is the Federal judgment rate.

The Noteholders respond that while unsecured creditors generally do not receive post-petition interest, under the "solvent debtor" rule they must receive post-petition interest at the contract rate for them to be considered unimpaired under the plan.

THE LEGAL FRAMEWORK

Section 502(b)(2) of the Bankruptcy Code provides. In part, that:

> (b) [T]he court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—
>
> ***
>
> (2) such claim is for unmatured interest

Section 1124 provides that a "class of claims . . . is impaired under a plan unless, with respect to each claim . . . of such class the treatment satisfies either subsection (1) or (2). Section 1124(1) provides that a class of claims is unimpaired if a plan "leaves unaltered the legal, equitable, and contractual rights to which such claim . . . entitles the holder of such claim."

Prior to 1994, section 1124 provided that "a class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan . . . (3) provides that, on the effective date of the plan, the holder of such claim or interest receives, on account of such claim or interest, cash equal to (A) with respect to a claim, the allowed amount of such claim." Because under section 502(b)(2) allowed unsecured claims do not include post-petition interest, under the plain meaning of section 1124(3)(A), a debtor could render an unsecured class unimpaired by paying the allowed claim in full without post-petition interest even if the debtor were solvent and providing a distribution to a junior class. Indeed, the New Jersey bankruptcy court so held in *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994). As described by Judge Walsh, "the result in New Valley stood in contrast with a line of cases holding that where a debtor is solvent, unsecured creditors must be paid in full, including postpetition interest, pursuant to the 'fair and equitable' test of section 1129(b)(2) when the debtor is cramming down that creditor's claim. Thus, solvent debtors could avoid paying 'unimpaired' unsecured creditors postpetition interest by paying them in full in cash, yet the same solvent debtor would be required to pay postpetition interest to an 'impaired' dissenting class of unsecured creditors." *In re PPI Enterprises (U.S.), Inc.*, 228 B.R. 339, 351 (Bankr. D. Del. 1998).

In 1994, Congress removed section 1124(3) from the Bankruptcy Code. The legislative history makes clear Congress's intent: "[i]n order to preclude [the] unfair result [of *New* Valley] in the future, the Committee finds it appropriate to delete section 1124(3) from the Bankruptcy Code." H.R.Rep. No. 835, § 214 (1994), reprinted in 1994 U.S.C.C.A.N. 3340.

Finally, however, one might consider whether a landlord's lease rejection claim was impaired by the statutory cap on the claim under section 502(b)(6) of the Code. Judge Walsh confronted this question in the *PPI Enterprises* case discussed above. The plan in *PPI Enterprises* purported to treat the landlord as unimpaired by paying him the entire amount of his section 502(b)(6) capped rent claim, plus pre- and post-petition interest. The landlord argued that the failure to pay him the full amount of his claim under state law for breach of his lease as opposed to the allowed amount of his claim capped under section 502(b)(6) altered "the legal, equitable, and contractual rights to which such claim . . . entitles the holder of such claim" and, thus, his

claim was impaired. Judge Walsh, however, disagreed, finding that the landlord was confusing "two distinct concepts: (i) plan impairment, under which the debtor alters the 'legal, equitable, and contractual rights to which [their] claim entitles the holder of such claim,' and (ii) statutory impairment, under which the operation of a provision of the Code alters the amount that the creditor is entitled to under nonbankruptcy law." *PPI Enterprises*, 228 B.R. at 353. Judge Walsh went on to state that "it is not PPI's Plan which proposes to alter [the landlord's] rent claim; PPI's Plan provides for payment in full of the capped rent claim plus interest. Instead, it is the operation of the Code itself that has altered the $4.7 million amount owed by PPI [under state law]. That $4.7 million is not a right of payment to which [the landlord] is entitled to as a result of his bankruptcy claim." *Id*.

But if the limit on rejection damages under section 502(b)(6) is statutory impairment not plan impairment then what about the exclusion of unmatured, i.e., postpetition, interest on unsecured claims under section 502(b)(2)? *See In re W.R. Grace & Co.*, 475 B.R. 34, 161 (D. Del. 2012) ("It is unlikely that the Third Circuit meant to sift the statutory grains of sand here so finely – if it found no impairment on the basis of application of subsection (b)(6) to a creditor's claim, then it stands to reason that there likewise would be no impairment from the application of subsection (b)(2).").

Are the Noteholders entitled to post-petition interest at the contract rate?

KEEPING IT ALL IN THE FAMILY

By Hon. Bess M. Parrish Creswell, M.D. Ala.

BACKGROUND

Boy Rich is the eldest son of a prominent local family involved in various business interests, of which the Debtor, Momma Rich, is the matriarch. Boy Rich owns a business (Richco Co.) that services truck fleets. Richco enters into a contract with Wheelco, Inc. which has a national contract to service a carrier's multi-stop truck fleet. The agreement between Wheelco and Richco requires Wheelco to sell parts to Richco at an agreed-upon cost, and in turn, Richco is to service and repair the carrier's fleet. Boy Rich personally guarantees Richco's obligations to Wheelco.

A few months later, the relationship sours. Soon, Richco owes more than $1.0M for the parts to Wheelco. Wheelco sues Richco and Boy Rich in district court and a judgment against both defendants is awarded in Wheelco's favor.

During the pendency of the district court case, Boy Rich and his family engaged in several suspicious transfers. When Wheelco finds out, Wheelco files another lawsuit against Richco, Boy Rich, Momma Rich, and other family members in district court alleging fraudulent transfers under the Alabama Uniformed Fraudulent Transfers Act. After two litigious years in district court, a bench trial is scheduled. On the day of the trial, neither Momma Rich (nor any other defendants) show up for court. Momma Rich's attorney informs the court that he has been asked by Momma Rich to "stand down" and not defend the case. Additionally, he requests the court allow him to withdraw as counsel. His request to withdraw is denied, and the trial proceeds as scheduled in lieu of a default judgment. Wheelco presents its evidence, and the district court enters judgment in favor of Wheelco. In its ruling, the district court makes the following findings of fact:

1. Momma Rich received transfers (directly or indirectly) totaling $1.2M from Richco and/or Boy Rich through various transactions between multiple business entities.
2. Momma Rich "willfully, intentionally, and maliciously" accepted the transfers with the "actual intent to injury, delay or defraud" Wheelco.

Shortly after judgment is entered by the district court in the second case, Momma Rich files a chapter 7 bankruptcy petition. Wheelco brings an adversary proceeding seeking a determination from the bankruptcy court that the judgment debt of $1.2M against Momma Rich is non-dischargeable under 11 U.S.C. § 523(a)(2)(A). Wheelco files a motion for summary judgment arguing there is no material issue of fact because the bankruptcy court should apply the doctrine of collateral estoppel to the district court's findings and that the transfers giving rise to the district court judgment were part of a fraudulent scheme that is nondischargeable under *Husky Int'l Elecs., Inc. v. Ritz*, 136 S. Ct. 1581 (2016).

ISSUES

Does the doctrine of collateral estoppel apply? In particular, is the issue of actual fraud identical in both the district court litigation and 11 U.S.C. § 523(a)(2)(A), was the issue of actual fraud litigated in the district court, and was a determination of actual fraud by Momma Rich a critical and necessary part of the district court judgment?

And, if collateral estoppel applies, is summary judgment warranted under *Husky Int'l Elecs.*?

LEGAL FRAMEWORK

Collateral Estoppel

The Eleventh Circuit has held that if the federal court's jurisdiction in ruling on the case at issue was based on diversity jurisdiction, then courts must look to the applicable state's rules of collateral estoppel. *CSX Transportation, Inc. v. Gen. Mills. Inc.* 846 F.3d 1333 (11th Cir. 2017). Under Alabama law, a movant seeking to employ the doctrine of collateral estoppel has the burden to show that the following elements are met (i) the issue must be identical to the one involved in the previous suit; (ii) the issue must have been actually litigated in the prior action; and (iii) the resolution of the issue must have been critical and necessary to the prior judgment. *Martin v. Reed*, 480 So.2d 1180, 1182 (Ala. 1985); *Conley v. Beaver*, 437 So.2d 1267, 1269 (Ala. 1983).

Identity of Issues/Critical and Necessary

Section 523(a)(2)(A) renders nondischargeable "money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . false pretenses, a false representation, or actual fraud." 11 U.S.C. § 523(a)(2)(A). In *Husky Int'l Elecs.,* the Supreme Court recognizes that claims for actual fraud under § 523(a)(2)(A) can also encompass forms of fraud, like fraudulent conveyance schemes. 136 S.Ct. 1581, 1586 (2016). The Supreme Court notes in *dicta* that recipients of fraudulent transfers could meet the "obtained by" requirement of § 523(a)(2)(A) and may be subject to nondischargeability actions for debts *traceable* to such transfers. *Id.* at 1589.

Looking to the identity of issues and critical and necessary elements, the AUFTA provides that a "transfer made by a debtor is fraudulent as to a creditor . . .. if the debtor made the transfer with actual intent to hinder, delay, or defraud any creditor of the debtor." ALA. CODE § 8-9A-4. However, in this case, Debtor is not the transferor of the transaction at issue in the second district court lawsuit, she is the transferee. Thus, Debtor argues that there was no identity of issues, and further, that actual fraud by Debtor was not a critical and necessary element of the district court's finding of liability as to Debtor.

Section 8-9A-7 of the AUFTA provides for the avoidance of transfers as a remedy to a creditor upon a finding of actual fraud, but that remedy is subject to the limitations of § 8-9A-8(a), which provides that a transfer is not voidable under § 8-9A-4(a) against a person who took in good faith

and for reasonably equivalent value. Is a finding of liability by the district court as to Debtor under this statute sufficient to satisfy the identity of issues and the critical and necessary requirement?

Actually Litigated

Debtor argues that the district court judgment was effectively a default judgment and that collateral estoppel should not apply as the result of ineffective assistance of counsel. She argues that her failure to attend the trial and her attorney's failure to present evidence or cross-examine witnesses rendered the judgment a de facto default judgment. Satisfaction of the "actually litigated" requirement requires that the issue has been effectively raised in the prior action, either in the pleadings or through development of the evidence and argument at trial, and that the losing party had a fair opportunity procedurally, substantively, and evidentially to contest the issue. *In re Peterson v. Woodland Homes of Huntsville, Inc*., 959 So.2d 135 (Ala. Civ. App. 2006). Is Momma Rich's absence from the trial and her attorney's failure to defend at the trial sufficient to support her position that she did not have a full and fair opportunity to litigate?

***Husky Int'l Elecs., Inc. v. Ritz*, 136 S.Ct 1581 (2016)**

Writing for the majority in *Husky Int's Elecs.*, Justice Sotomayor held that "actual fraud" under § 523(a)(2)(A) can encompass fraudulent conveyance schemes. In *dicta* she states that while the transferor of a fraudulent conveyance does not "obtain" debts in a fraudulent conveyance, the recipient of the transfer, who with the requisite intent also commits fraud, can "obtain" assets "by" his or her participation in the fraud. And in the rare case (like the one we have here), if that recipient later files for bankruptcy, any debts "traceable to" the fraudulent conveyance will be nondischargeable under § 523(a)(2)(A).

However, in a strong dissent, Justice Thomas disagrees that "actual fraud" encompasses fraudulent transfer schemes and argues that "obtained by" should be limited in scope to only situations in which money, property, or services are obtained by . . . actual fraud and results in the debt – or only applies when the fraudulent conduct occurs at the inception of the debt (i.e. when debtor commits a fraudulent act to induce the creditor to part with his money, property, services or credit).

So, if collateral estoppel is applicable, is the judgment debt non-dischargeable under *Husky Int's Elecs.*?