AMERICAN BANKRUPTCY INSTITUTE

New York City Bankruptcy Conference

CONCURRENT SESSION

Legal and Practical Issues and Implications of Enforcing Judgments Inside and Outside of Bankruptcy

David M. Posner, Moderator
Kilpatrick Townsend & Stockton LLP

Sara L. Brauner
Akin Gump Strauss Hauer & Feld LLP

Hon. James L. Garrity, Jr.
U.S. Bankruptcy Court (S.D.N.Y.)

Ira L. Herman
Blank Rome LLP

Mark T. Iammartino
Development Specialists, Inc.; Chicago

Samuel S. Kohn
Dorsey & Whitney LLP

2024

Legal and Practical Issues and Implications of Enforcing Judgments Inside and Outside of Bankruptcy

Enforcing Judgments Outside of Bankruptcy

Recognition of U.S. Court Judgments

- Judgments issued by a Unites States court are enforceable in every state as a result of the Full Faith and Credit Clause.
  - In New York, the judgment may be registered with the clerk or the plaintiff can bring an action on the judgment or seek summary judgment in lieu of complaint (CPLR § 5406).
  - 28 U.S.C. § 1963 provides for registration of a federal court judgment in any federal court.
- Personal jurisdiction over the judgment debtor is not required. *Breezevale Ltd. v. Dickinson*, 262 A.D.2d 248 (N.Y. 1999).

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Recognition of Foreign Judgments

- Covered by the Uniform Foreign Country Money Judgments Act.
- In New York, Article 53 of the CPLR.
- In New York, the judgment creditor can file an action on the judgment or summary judgment in lieu of complaint.
- No personal jurisdiction is needed over the judgment debtor. *Abu Dhabi Comm. Bank PJSC v. SAAD Trading, Contracting and Fin. Servs. Corp.*, 117 A.D.3d 609 (N.Y. 2014).
- In federal court, there must be an independent basis for subject matter jurisdiction.

The Uniform Foreign Country Money Judgments Act

- Civil judgment granting or denying a recovery of a sum of money.
- Judgment must be final, conclusive, and enforceable where rendered.
- The foreign judgment must *not* be a judgment for: taxes, fines, or other penalties.
- In addition, many states have recognition statutes that contain a savings clause: "This Act does not prevent the recognition of a foreign judgment in situations not covered by this Act."

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Key Defenses Against Recognition of Foreign Judgments

- **CPLR § 5304(a):** A foreign judgment is not enforceable if:
  - judgment was rendered by a system that does not afford impartial tribunals or procedures compatible with due process;
  - the foreign court did not have personal jurisdiction over the defendant; or
  - the foreign court did not have subject matter jurisdiction.
- **CPLR § 5304(b):** A foreign judgment *may* not be enforceable if:
  - the defendant in the foreign action did not receive notice of the proceedings in sufficient time to enable him to defend the suit;
  - judgment was obtained by fraud;
  - judgment is based on a cause of action repugnant to public policy;
  - judgment conflicts with another final and conclusive judgment;
  - judgment is contrary to an agreement between the parties to resolved the dispute out of court;
  - in the case of jurisdiction based only on personal service, the foreign court was a seriously inconvenient forum;
  - the judgment was rendered in circumstances that raise substantial doubt about the integrity of the rendering court;
  - the specific proceeding was not compatible with due process; or
  - The cause of action resulted in a defamation judgment outside the Unites States, unless the court determines the foreign court provided as much protection for freedom of speech in that case as would be provided in the U.S.

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Planning for Enforcement

- Foreign venue: try to carry out your foreign litigation in a venue likely to produce a judgment you can defend.
- Judgment needs to be final and enforceable (determined by the law of the jurisdiction in which it was entered).
- Consider potential for pre-judgment attachment.
- Be prepared for counterclaims and key defenses.
- Consider statute of limitations.
- Consider timing of recognition actions in multiple jurisdictions.
- Keep an eye on other creditors of the debtor.

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Identifying Potential Sources of Judgment Repayment

- Who is the judgment creditor? Start with a search of your own files for evidence of debtor assets.
    - Payment records to identify banking partners; from where did the wire, ACH, or check originate?
    - Credit applications, KYC documents, or other diligence items.
    - Any prior emails discussing debtor's businesses .
- Review public documents such as SEC filings, press releases of major transactions or initiatives, and social media postings.
- Perform background checks using commercial services such as D&B, credit bureaus (TLO), data brokers and other skip tracing services including private investigators.
- Cross-reference publicly known details with other databases e.g. entity registration information with Secretary of State records.
- Litigation searches.
- Take discovery – obtain access or copy of the debtor's accounting systems, financial statements and trial balances, tax returns, and bank records to identify potential asset purchases or transfers of money.

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Pre-Judgment Remedies: Attachment

- **CPLR § 6201:** May be granted in an action in which a plaintiff seeks a money judgment when:
  - the defendant is a nondomiciliary residing without the state, or is a foreign corporation not qualified to do business in the state; or
  - the defendant resides or is domiciled in the state and cannot be personally served despite diligent efforts to do so; or
  - the defendant, with intent to defraud his creditors or frustrate the enforcement of a judgment that might be rendered in plaintiff's favor, has assigned, disposed of, encumbered or secreted property, or removed it from the state or is about to do any of these acts; or
  - the action is brought by a victim of a crime (or their representative) against a person convicted of committing such crime (or their representative); or
  - the cause of action is based on a domestic or foreign judgment entitled to recognition.
- Use pre-judgment attachment:
  - to gain priority over other creditors;
  - to create a security lien where the debtor may file for bankruptcy;
  - in connection with a suit seeking recognition of a foreign money judgment.

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All Property Interests are Subject to Enforcement

- Real property – filing judgment in county where property is located gives you a lien
- Bank accounts
- Lawsuits (*Breezevale Ltd. v. Dickinson*, 262 A.D.2d 248 (N.Y. 1999))
- Debts owed to judgment debtors
- Intellectual property
- Receivables
- Dividends paid to shareholders during the lawsuit
- Wages – can be reached through income execution/wage garnishment

Transcript of Judgment

In some states, a judgment automatically gives the creditor a lien on the judgment debtor's property. In New York, the creditor must file a transcript of judgment with the county clerk in the county where the judgment debtor's assets are located.

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Asset Freezes

- If the action seeks equitable relief, the district court may restrain the debtors' assets within or without the state. *Gucci Am. Inc. v. Bank of China*, 768 F.3d 122, 230 (2d Cir. 2014).
- If the action is for money damages only, the court lacks equitable authority to freeze the defendants' assets. *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 119 S. Ct. 1961, 1975 (1999) (holding that the court lacked authority to issue a preliminary injunction preventing disposition of defendant's assets in a suit seeking money damages).
- However, an asset restraint can be obtained pursuant to Federal Rule of Civil Procedure 64 if the requirements for a pre-judgment attachment under state law are met.

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Post-Judgment Remedies

- Post-judgment discovery
- Restraining notice
- Turnover order
- Injunctions
- Appointing a receiver

Time to Enforce a Judgment

In New York, a judgment is enforceable for 20 years, but a judgment lien on real property must be renewed after 10 years.

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Discovery in Aid of Execution

- Broad discovery is available. *EM Ltd. v. Republic of Argentina*, 695 F.3d 201, 207 (2d Cir. 2012), *aff'd sub nom.*, *Republic of Argentina v. NML Capital, Ltd.*, 134 S. Ct. 2250 (2014) ("[B]road post-judgment discovery in aid of execution is the norm in federal and New York state courts.").
- May conduct discovery pursuant to state procedure or Federal Rule of Civil Procedure 69.
- CPLR § 5224(4)(a-1) expressly provides for discovery of documents within or without the state.

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Ability to Obtain Worldwide Discovery

***Gucci Am. Inc. v. Bank of China*, 768 F.3d 122 (2d Cir. 2014)**

- Gucci sued counterfeiters who transferred the profits of their counterfeit sales to accounts at Bank of China.
- Gucci served Bank of China with a subpoena at its New York branch office seeking information about the counterfeiters' bank accounts.
- Bank of China refused to produce on grounds of Chinese bank secrecy law.
- The district court ordered Bank of China to produce documents and ultimately found Bank of China in contempt for failure to produce.
- The Second Circuit remanded the case for consideration of whether the district court had specific personal jurisdiction over Bank of Chine to enforce the subpoena.
- The district court found specific jurisdiction over the bank (*Gucci Am. Inc. v. Weixing Li, et al.*, 2015 WL 5707135 (S.D.N.Y. Sep. 29, 2015)).
- Bank of China had established correspondent accounts in New York to facilitate dollar transfers from the U.S. to China, advertised its New York branches as "the first choice of U.S. dollar wire transfers to and from China," and "frequently and deliberately used its New York correspondent account with Chase in New York to effectuate wire transfers for its U.S. clients, including, critically, Defendants in this action."

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Restraining Notices: CPLR § 5222

- May be served by an attorney.
- May be served on anyone except judgment debtor's employer.
- Serve on banks or business entities with which the judgment debtor does business.
- Does not create a lien.
- Must follow up with turnover proceeding to obtain the funds.

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Turnover Orders: CPLR § 5225

- Motion may be served on judgment debtor or special proceeding commenced as to garnishee.
- Requires showing that the judgment debtor is in possession or custody of money or other personal property in which he has an interest.
- As long as the court has personal jurisdiction over the judgment debtor or garnishee, the court can order the turnover of assets from anywhere in the world. *Kohler v. Bank of Bermuda Ltd.*, 12 N.Y.3d 533, 541 (2009) ("[W]e hold that a New York court with personal jurisdiction over a defendant may order him to turn over out-of-state property regardless of whether the defendant is a judgment debtor or a garnishee.")
- Conflict with foreign law analyzed under Restatement (Third) of Foreign Relations Law § 403.
- ***Yukos Capital v. Samaraneftegaz*, 2014 WL 81563 (S.D.N.Y. 2014)**:
    - As part of its enforcement strategy, Yukos Capital obtained a turnover order pursuant to NY CPLR § 5525, requiring Samaraneftegaz to bring assets into the jurisdiction sufficient to pay the judgment (or post a bond).
    - The district court also enjoined Samaraneftegaz from paying further dividends to its parent, finding that it had fraudulently transferred more than $1 billion while the litigation was pending.
    - The Second Circuit later vacated the order without expressing any view on the merits of the order, directing the district court to clarify its ruling with respect to alternative service and comity issues.

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Injunctions

- The Second Circuit has held that a judgment debtor's "persistent efforts to frustrate the collection of money judgments" constitutes irreparable harm warranting equitable relief.
- ***NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012):** The Second Circuit affirmed the district court's injunction prohibiting Argentina from making payments to exchange bondholders without making ratable payments to the bondholders whose bonds were in default.
- ***Pashaian v. Eccelston Props, Ltd.*, 88 F.3d 77, 87 (2d Cir. 1996)**: The Second Circuit affirmed the district court's injunction against fraudulent transfers intended to frustrate the judgment.

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Appointment of a Receiver: CPLR § 5228

- Upon motion of the judgment creditor, the court may appoint a receiver to collect and sell the judgment debtor's property.

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Prepetition Settlements

Settlements with Potentially Distressed Entities

Risk 1: Parties enter into a settlement agreement where one party is required to make future payment(s) or payments over time in exchange for a release. The risk is that the party making the payments can file for bankruptcy and obtain a discharge.

- Mitigate such risk by:
  - Obtaining a security interest that must be perfected in accordance with applicable nonbankruptcy law prior to preference period.
  - Enter into a stipulated judgment.
  - Agreement's provision should explicitly include the preservation of any non-dischargeable nature of the claim as outlined in section 523(a) of the Bankruptcy Code.

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Settlements with Potentially Distressed Entities

Risk 2: Payment(s) pursuant to a prepetition settlement agreement may be avoided as a preferential or fraudulent transfer and subject to clawback. Security interest in the prospective debtor's property may be subject to avoidance as a preference if the prospective debtor files for bankruptcy less than 90 days after the perfection of the security interest.

- Mitigate such risk by:
  - Arranging for payment as soon as possible.
  - Requiring payments to be made by a third party as earmarked funds (however, beware of substantive consolidation risk).
  - "Springing release" – include in the settlement agreement a provision delaying the release of claims until 91 days after payment, the time at which the payment would be protected from avoidance, assuming that the debtor is not an insider of the releasing party (the insider preference reach back period is one year, rather than 90 days). Include provision that claim will not be reduced or released until 91 days have passed after the last payment without a bankruptcy filing (may be subject to *ipso facto* challenge).
  - "Springing claim" – at minimum, include a provision in the agreement that in the event of a clawback of settlement payments, creditor will have rights to pursue full amount of the pre-settlement amount of the claim against debtor.

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Enforcing Judgments in Bankruptcy

Automatic Stay

- A creditor may be unable to collect a judgment if the judgment debtor appeals to the judgment **or files for bankruptcy.**
- Upon a bankruptcy filing, the automatic stay halts collection efforts by creditors. *See* 11 U.S.C. § 362.
- Any pending action may not proceed and the creditor may not foreclose or take possession of the collateral without an order of the Bankruptcy Court granting relief of the automatic stay.

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Effect of Bankruptcy on Judgment

- Judgments are generally classified as unsecured debt in bankruptcy if the judgment is not properly secured and perfected.
- Main types of liens:
    - Consensual liens:
        - Purchase-money security interest liens (e.g., mortgage and car loan)
        - Non-purchase-money security interest liens (e.g. second mortgage)
    - Judgment liens:
        - From a court judgment
        - May result in bank lien or wage garnishment
    - Statutory liens:
        - Tax/mechanic's liens

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Effect of Bankruptcy on Judgment (con't)

- The bankruptcy trustee's strong-arm powers under 11 U.S.C. § 544(a): the trustee or debtor-in-possession can avoid any transfer made or obligation incurred by the debtor that would be voidable by a judgment lien creditor under nonbankruptcy law. The trustee takes priority over the lender's unperfected security interest, relegating the creditor to the position of unsecured creditor.
- If a creditor has obtained a lien on the judgment debtor's property, the lien may be avoided in bankruptcy if the property subject to the lien is exempted/protected property. *See* 11 U.S.C. § 522(f).
    - Can be brought by motion. *See* Fed. R. Bankr. P. 4003.
- Liens filed within the preference period (within 90 days (or one year for insiders) before bankruptcy filing) are subject to avoidance for the full amount of the lien. *See* 11 U.S.C. § 547.
- For secured creditors, priority is generally determined by the "first in time" approach, with some exceptions.

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Perfection: Mortgages vs. Judgment Liens

- A lien must be properly perfected to be a secured debt that is enforceable by the bankruptcy courts. Adherence to the technical requirements for perfection is essential.
- Mortgage or purchase money security interest:
    - Legal form of security that attaches to real estate collateral to guarantee payment of a debt.
    - Must include language granting the security interest in the security documents.
    - Perfection occurs when the lender records the mortgage or deed of trust in the land records, typically with the county where the real property is located.

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Perfection: Mortgages vs. Judgment Liens (con't)

- A judgment lien is perfected by "docketing" a money judgment with the county clerk in a county where the judgment debtor has an interest in real property. *See* CPLR 5203(a).
    - "Docketing" is a separate act from "entering" a judgment, conducted by the county clerk, with the sole purpose of which is to create a judgment lien on any real property in that county in which the judgment debtor has an interest. *See* CPLR 5018(a) ("Immediately after filing the judgment-roll, the clerk shall docket a money judgment, and at the request of any party specifying the particular adverse party or parties against whom docketing shall be made, the clerk shall so docket a judgment affecting the title to real property").
    - If the property is located in a county other than the one where a Supreme Court judgment was entered, if the judgment originates in a lower court, e.g. New York City Civil Court or the Nassau County District Court, or from a federal court in New York, one must obtain and then file a "transcript of judgment" with the county clerk to obtain a judgment lien. *See* CPLR 5018(a).
    - In New York, judgment liens are not filed against specific parcels of real property. Rather, they extend to all property interests held by the debtor in the county where the judgment is docketed. *See* CPLR 5203(a); *Grygorewicz v. Domestic & Foreign Disc.*, 179 Misc. 1017 (Sup. Ct. 1943) ("A judgment isn't docketed against any particular property, but solely against a name."). This is also called a "floating lien."
    - A judgment lien on real property is only effective for 10 years. *See* CPLR 5203(a). However, a judgment lien can be renewed and extended for another 10 years by commencement of an action seeking that relief within one year prior to the expiration of the lien. *See* CPLR 5014(1).

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Perfection: Other Non-Statutory Liens

- Perfection of security interest by filing a UCC financing statement.
    - The filing of a financing statement is an alternative method of perfecting a security interest in goods, negotiable documents, instruments, chattel paper, and investment property.
    - To be valid, the filed document must contain (1) the names of the debtor and the secured party and (2) a description of the collateral that "reasonably identifies what is described." UCC § 9-502(a), 9-504, 9-108.
    - Must be filed with the Department of State located in the jurisdiction where the corporate debtor is incorporated.
    - UCC Article 9 permits perfection of a security interest by control for investment property, depository accounts, electronic chattel paper, and letters of credit.

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Nondischargeable Debts

Non-Dischargeable Debts

- Non-dischargeable debts include, among others:
  - Student loans;
  - Child/spousal support;
  - Debts owed to government entities (e.g. taxes);
  - Certain loans owed to pension/profit sharing/stock bonus/retirement plans.
- Debts that *may* be non-dischargeable upon creditor objection include debts resulting from:
  - Injury caused by a willful or malicious act (e.g. assault);
  - Fraud;
  - Deception committed while in a position of trust (e.g. embezzlement while acting as a trustee or guardian).

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Alex Jones & Nondischargeable Defamation Claims in Chapter 11

Background on Sandy Hook, Alex Jones, and Free Speech Systems

- On December 14, 2012, a lone gunman shot and killed 20 first graders and six adults at Sandy Hook Elementary School in Newtown, CT.
- Alex Jones is a media personality and conspiracy theorist who broadcasts a daily show, The Alex Jones Show, on radio, internet, and podcast platforms. Jones is the sole owner of his media company, Free Speech Systems, LLC ("FSS").
- Beginning on the day of the Sandy Hook Elementary school shooting, and continuing for more than a decade thereafter, Jones launched a campaign of lies, including that the shooting never took place, that the children who were killed were fictional characters, or "holograms," and that their parents—as well as those children who survived the attack—were actors perpetrating a fraud for financial or political purposes.
- Jones's defamatory campaign resulted in prolonged harassment of the families of the victims of the Sandy Hook shooting by numerous members of Jones's audience.
- In mid-2018, two groups of family members—the Texas and Connecticut Plaintiffs—commenced lawsuits in respective state courts against Jones and FSS for, among other things, defamation, intentional infliction of emotional distress ("IIED"), and invasion of privacy, which actions resulted in judgements of more than $1 billion in compensatory and punitive damages.
- As a result of the staggering litigation, FSS commenced a case under subchapter V of chapter 11 of the Bankruptcy Code on July 29, 2022 (the "FSS Bankruptcy Case"), and Jones commenced an individual case under chapter 11 of the Bankruptcy Code on December 2, 2022 (the "Jones Bankruptcy Case"), each in the United States Bankruptcy Court for the Southern District of Texas before the Honorable Christopher M. Lopez.

Underlying Texas State Court Litigation

- In the April 2018, the Texas Plaintiffs initiated civil state court lawsuits against Jones and FSS, alleging defamation, defamation per se, and IIED. Two of the three lawsuits filed were consolidated, leaving the *Heslin/Lewis* action and the *Pozner/De La Rosa* action.
- In 2021, the Texas state court granted each of the plaintiffs a default judgment on account of Jones's failure to obey discovery orders and disregard of his discovery obligations.
- At a trial to determine damages in the *Heslin/Lewis* action, the jury awarded Heslin and Lewis more than $4 million in compensatory damages and approximately $45 million in exemplary damages.
- The *Pozner/De La Rosa* Action did not proceed to a damages trial before Jones and FSS filed their respective bankruptcy cases, staying such action.

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Underlying Connecticut State Court Litigation

- In May 2018, the Connecticut Plaintiffs initiated civil state court lawsuits against Jones and FSS, alleging invasion of privacy, defamation, defamation per se, IIED, and violations of the Connecticut Unfair Trade Practices Act ("CUTPA").
    - The three lawsuits filed were consolidated into one—the *Lafferty* action.
- In 2021, the Connecticut state court similarly granted the plaintiffs a default judgment on account of Jones's repeated violations of discovery orders.
- At a trial to determine damages, the jury awarded a total of $965 million in compensatory damages and over $470 million in additional common law and statutory punitive damages for a total of just under $1.5 billion.

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Dischargeability of State Court Judgments in Jones & FSS Bankruptcy Cases

- On July 29, 2022, Jones caused FSS to file the FSS Bankruptcy Case under subchapter V of chapter 11 of the Bankruptcy Code, which subchapter was created by the Small Business Reorganization Act of 2019 to provide an easier and more streamlined path to reorganization for small businesses.
- On December 2, 2022, Jones commenced the Jones Bankruptcy Case as an individual debtor under chapter 11.
- Akin represents the Official Committee of Unsecured Creditors appointed in the Jones Bankruptcy Case, which comprises representatives of the Texas and Connecticut Plaintiffs.

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- One of the central issues in these cases was whether the Texas and Connecticut Plaintiffs' state court judgments could be ***discharged*** in bankruptcy.
    - Pursuant to Bankruptcy Code section 523, debts incurred for "***willful and malicious injury by the debtor to another entity***" are ***not dischargeable*** in bankruptcy. 11 U.S.C. § 523(a)(6) (emphasis added).

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Dischargeability of State Court Judgments in Jones & FSS Bankruptcy Cases, *cont'd.*

- There was no question as to whether Bankruptcy Code section 523 applied in the Jones Bankruptcy Case such that Jones could not discharge any debts that constituted "willful and malicious injury" to creditors. Therefore, the Texas Connecticut Plaintiffs each commenced an adversary proceeding to confirm the nondischargeability of their respective state court judgments.
    - Each state court had found that at least some of Jones's actions were "willful and malicious."
- There was at that time, however, an open legal question as to the applicability of Bankruptcy Code section 523 in the FSS Bankruptcy Case. Specifically, at that time, there was a Circuit split as to whether subchapter V corporate debtors are subject to the exceptions to discharge contained in Bankruptcy Code section 523(a). Among other provisions, subchapter V added Bankruptcy Code section 1192, which allows a debtor—whether an individual or business—to discharge debts that arose before confirmation of the plan except debts "**of the kind specified in** [Bankruptcy Code section 523(a)]." 11 U.S.C. § 1192 (emphasis added).
    - This language arguably conflicts with Bankruptcy Code section 523(a), the preamble to which explicitly limits that section to **individual debtors**: "A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge **an individual debtor** from any debt . . . ." 11 U.S.C. § 523(a) (emphasis added).

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Dischargeability of State Court Judgments in Jones & FSS Bankruptcy Cases, *cont'd.*

- Thus, there remained an open question as to whether businesses in subchapter V may similarly be subject to the exceptions to discharge contained in Bankruptcy Code section 523(a). Courts grappling with this question have reached differing conclusions.
    - *Cantwell-Cleary v. Cleary Packaging (In re Cleary Packaging)*, 36 F.4th 509 (4th Cir. 2022) (holding that unlike corporate debtors in traditional chapter 11 cases, corporate subchapter V debtors are subject to Section 523(a) to the same extent as individual debtors and, as such, can be denied a discharge).
    - *Avion Funding, L.L.C. v. GFS Industries, L.L.C. (In re GFS Industries, LLC)*, 647 B.R. 337 (Bankr. W.D. Tex. 2022) (holding that the limiting preamble in Bankruptcy Code section 523(a)'s precludes application to corporate debtors in subchapter V to the same extent as corporate debtors in chapter 11).
- **As noted below, however, the 5th Circuit in Avion Funding has now determined that Bankruptcy Code section 523 applies with equal force in a case commenced under subchapter V. *See Avion Funding L.L.C. vs. GFS Industries, L.L.C. (In re GFS Industries, L.L.C.)*, No. 23-50237 [ECF No. 89] (5th Cir. April 17, 2024).**
- In light of the uncertain status at the time, however, the Texas and Connecticut Plaintiffs determined to defer and reserve rights with respect to any determination regarding the nondischargeability of their claims in the FSS Bankruptcy Case.

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Dischargeability of State Court Judgments in Jones & FSS Bankruptcy Cases, *cont'd.*

Cleary Packaging

- In *Cleary Packaging*, the Fourth Circuit held that Bankruptcy Code section 523(a) exceptions to discharge ***apply*** to corporate debtors in subchapter V cases to the same extent as individual chapter 11 debtors.
- The court observed that Bankruptcy Code section 1192 provides specifically for the discharge of debts of a kind as specified in Bankruptcy Code section 523(a), but does not specify the type of debtor. Noting that both individual and corporate debtors are covered by Bankruptcy Code section 1192, the court reasoned that neither is exempt from the "types of debt described in Bankruptcy Code section 523(a)."
- The court stated that allowing Bankruptcy section 523(a)'s discharge exemptions to apply to both individual and corporate debtors upheld Congressional intent in creating subchapter V—simplifying chapter 11 reorganizations for small businesses.

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Dischargeability of State Court Judgments in Jones & FSS Bankruptcy Cases, *cont'd.*

GFS Industries

- In *GFS Industries*, the Bankruptcy Court for the Western District of Texas held that Bankruptcy Code section 523(a) exceptions to discharge ***do not apply*** to corporate debtors in subchapter V cases.
- In contrast to the Fourth Circuit, this court read the language of Bankruptcy section 523(a) as limiting its application solely to individual debtors. Reconciling this reading with the language of Bankruptcy Code section 1192, the court concluded that Bankruptcy Code section 1192's reference to Bankruptcy Code section 523(a) incorporates that section without expanding its scope to corporate debtors.
- The court stated that its ruling comported with the statutory intent of subchapter V by expanding the principles of chapter 11.
- In April 2024, the Fifth Circuit issued an opinion reversing the bankruptcy court, holding that Bankruptcy Code section 523(a) exceptions to discharge ***do apply*** to corporate debtors in subchapter V cases. Specifically, the 5th Cir determined that Bankruptcy Code section 1192 governs the discharge of debts of a "debtor," which the Bankruptcy Code defines as encompassing both individual and corporate debtors. The 5th Cir also noted that other Bankruptcy Code provisions expressly limit discharges to "individual" debtors, whereas Bankruptcy Code section 1192 provides a discharge for "the debtor" without qualification. Therefore, the 5th Cir concluded that Bankruptcy Code section 1192(2) subjects both corporate and individual subchapter v debtors to the categories of debt discharge listed in Bankruptcy Code section 523(a) and, thus, reversed the judgment of the bankruptcy court and remanded for further proceedings consistent with the ruling.

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Summary Judgment Rulings on Nondischargeability in Jones Bankruptcy Case

- On May 10, 2023, the Texas and Connecticut Plaintiffs filed motions for summary judgment in the Jones Bankruptcy Case, arguing that their default judgments established that the Debtor had committed "willful and malicious injury" against them.
- On October 19, 2023, the Bankruptcy Court issued summary judgment rulings in each of the adversary proceedings, holding that a portion of each of the state court judgments was nondischargeable pursuant to Bankruptcy Code section 523(a)(6).
- **Texas Plaintiffs:** With respect to the Texas Plaintiffs, the Bankruptcy Court held that: (i) the portion of the judgment based on defamation, in the amount of $4.3 million, was nondischargeable because Jones acted intentionally; but (ii) the portion (if any) of the judgment based on Jones's merely reckless conduct in committing IIED would be dischargeable.
    - In reviewing the jury instructions presented at trial, the Bankruptcy Court found that the damages awarded for defamation flowed from allegations of Jones's intent to harm, rendering it nondischargeable.
    - With respect to IIED, however, the Bankruptcy Court could not determine how much of the jury award was based on willful and malicious injury as opposed to recklessness conduct.
    - Because any damage award based merely on recklessness would be dischargeable in bankruptcy, the Bankruptcy Court held that a trial on damages was needed for the Heslin/Lewis and Pozner/De La Rosa Actions to determine the amount of the IIED jury award that is nondischargeable.

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Summary Judgment Rulings on Nondischargeability in Jones Bankruptcy Case, *cont'd.*

- **Connecticut Plaintiffs:** With respect to the Connecticut Plaintiffs, the Bankruptcy Court granted summary judgment on all claims (for a total of approximately $1.12 billion), except the jury's award of common law punitive damages ($323.15 in attorneys' fees and costs).
    - In reviewing the state court record, the Bankruptcy Court found that the compensatory and common law damage portions of the judgment were nondischargeable because they were based on findings that Jones was intentionally liable for defamation and IIED.
    - However, the Bankruptcy Court found that the common-law punitive damage portion of the Connecticut judgment could have been awarded based on Jones's merely reckless conduct.
    - The Bankruptcy Court granted summary judgment on the $1.12 billion in compensatory and CUTPA damages awarded by the state court but denied summary judgment on the $323.15 million in attorneys' fees and costs awarded as common law punitive damages.

Now that the 5th Cir has determined that the exceptions to discharge found in Bankruptcy Code section 523 apply with equal force to corporate debtors in subchapter v, the parties expect the same findings by the Bankruptcy Court in the Jones Bankruptcy Case would apply in the FSS Bankruptcy Case and will endeavor to formulate a stipulation or other resolution to these issues.

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More on Dischargeability: Attorney Sanctions and Penalties

Overview of § 523(a)(7)

11 U.S.C. § 523(a)(7) provides that a discharge for an individual does not discharge the following debts:

> (7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of ta governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—
>
> > (A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or
> >
> > (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition …

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Elements for Non-Dischargeability of Attorney Sanctions and Penalties

- Must be "a fine, penalty, or forfeiture."
  - Not defined under the Bankruptcy Code.
  - Courts look to the ordinary meaning of the terms.
- Must be payable to and for the benefit of a "Government Unit."
  - Prevents application to wholly private penalties, such as punitive damages.
  - 11 U.S.C. § 101(27): The term "governmental unit" means United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government.
- May not be compensation for actual pecuniary loss.

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Overview of State Bar Sanctions and Elements of a Discipline Order

- Types of funds ordered to be paid:
  - Costs
  - Restitution
  - Client Security Fund (CSF) Payments
- Payment of these elements may be a condition of reinstatement

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Non-Dischargeability of Attorney Sanctions and Penalties

- **Bankruptcy Discharge and State Bar Discipline Sanctions and Costs**
  - Costs consistently held *not* dischargeable.
  - *In re Findley*, 593 F.3d 1048, 1054 (9th Cir. 2010).
- **Dischargeability of Payments for Restitution or CSF**
  - Split of authority.
  - View that they are dischargeable:
    - *In re Scheer*, 819 F.3d 1206, 1211-12 (9th Cir. 2016).
    - *In re Albert-Sheridan*, 960 F.3d 1188, 1195 (9th Cir. 2020).
    - *Kassas v. State Bar of California*, 49 F.4th 1158 (9th Cir. 2022).
  - View that they are *not* dischargeable:
    - *In re McKee*, 648 B.R. 147 (Bankr. E.D. Pa. 2023).
    - *In re Fracis*, 647 B.R. 844 (Bankr. E.D. Va. 2022).

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Faculty

Sara L. Brauner is a partner with Akin Gump Strauss Hauer & Feld LLP in New York, where she focuses her practice on corporate restructurings, with an emphasis on official creditor committee and bondholder representations in large, complex chapter 11 cases. She represents official creditor committees, bondholders, noteholders, institutional investors, hedge funds and other interested parties in large-scale financial restructurings. Ms. Brauner has experience across an array of industries, including retail, oil and gas, pharmaceuticals and life sciences, media, and gaming and hospitality. She also is the firm's hiring partner for the New York Office and oversees student recruitment efforts and the summer associate program. Ms. Brauner has been listed in *The Legal 500 US* for Restructuring (including bankruptcy): corporate for 2023, in *Turnarounds & Workouts* as an Outstanding Young Restructuring Lawyer for 2022, as one of the Top Women in Dealmaking in *The Deal* for 2022, and as a Rising Star in *Euromoney's Expert Guides* for 2022. She received her B.A. *magna cum laude* in 2005 from Tufts University and her J.D. with honors in 2010 from The George Washington University Law School.

Hon. James L. Garrity, Jr. is a U.S. Bankruptcy Judge for the Southern District of New York in New York, sworn in on Feb. 17, 2015. Previously, he was a partner in the law firm of Morgan Lewis & Bockius LLP and co-head of its Bankruptcy & Restructuring group, where his practice included the representation of debtors, creditors, and other parties in chapter 11 cases and out-of-court restructurings. Prior to joining Morgan Lewis & Bockius, Judge Garrity was a partner at Shearman & Sterling LLP in its Financial Restructuring & Insolvency Group, and before that he served as a U.S. Bankruptcy Judge in the Southern District of New York from July 1991 to December 1999. Prior to his first term on the bench, he served as an assistant U.S. attorney for the Southern District of New York, inlcuding serving as chief of the office's Tax & Bankruptcy Unit, and was an associate at the New York law firm of Andersen, Russell, Kill & Olick, P.C. Judge Garrity is a Fellow in the American College of Bankruptcy, a member of the American Law Institute and a member of the International Insolvency Institute. He is also an adjunct professor at St. John's University School of Law's LL.M. in Bankruptcy program. Judge Garrity received his B.A. from the College of the Holy Cross in 1977, his J.D. from St. John's University School of Law in 1980 and his LL.M. in Taxation from New York University School of Law in 1986.

Ira L. Herman is a partner with Blank Rome LLP in its New York office, where he concentrates his practice on restructuring and bankruptcy matters with an emphasis on distressed public debt issues, secured and unsecured loans, cross-border insolvency matters, distressed M&A and corporate governance. He regularly counsels lenders and other constituencies regarding bankruptcy risk, including with regard to inter-creditor issues. Additionally, he advises financially distressed entities and their management on restructuring and bankruptcy issues, in and out of court, including corporate governance issues. Mr. Herman is a court-appointed mediator, and he has facilitated the resolution of controversies involving U.S. and non-U.S. parties concerning bankruptcy and commercial law issues. He annually updates "Anticipating and Managing Bankruptcy Risk," a series of articles he has written for the Financial Restructuring & Bankruptcy module of LexisNexis Practical Guidance®. He has served for five years on its editorial advisory board and has also served on *Law360*'s Bankruptcy Editorial Advisory Board. In 2022, Mr. Herman updated the chapter titled "Bankruptcy" in the trea-

tise *Negotiating and Drafting Commercial Leases* (Full Court Press 2022). He received his B.A. in political science *cum laude* from Yeshiva University in 1979, where he served as editor-in-chief of *The Polis*, a political science journal, and his J.D. *cum laude* with distinction from Boston University School of Law in 1982, where he served as an editor of the *Boston University International Law Journal*.

Mark T. Iammartino, CPA, CIRA is a senior managing director at Development Specialists Inc. in Chicago and has more than 20 years of consulting experience in corporate turnaround management, restructuring services, credit analysis and due diligence. His expertise includes facilitating creditor negotiations, designing and implementing cost-reduction and turnaround initiatives, exploring and executing strategic options such as a corporate sales or refinancing, and improving cash and liquidity management. He also advises lenders, unsecured creditors, investors and other capital providers to enable them to better understand and evaluate their options and potential recoveries with regards to their portfolio companies currently in distressed or crisis situations. Mr. Iammartino has worked across a wide variety of industries located both domestically and internationally. His industry experience includes manufacturing and distribution, financial services, health care, agribusiness, gaming, and consumer and business services companies. Prior to joining DSI in 2018, Mr. Iammartino was with MorrisAnderson and spent more than a dozen years with Ernst & Young and Arthur Andersen. He received his Bachelor's degree in finance and accounting from the University of Illinois at Urbana-Champaign and his M.B.A. from the University of Chicago Booth School of Business.

Samuel S. Kohn is a partner in the New York office of Dorsey & Whitney LLP and practices in the area of business reorganizations, including complex chapter 11 cases and out-of-court restructurings. He represents large corporate debtors, creditors' committees, secured lenders, distressed-asset-acquirers, investment funds and banks. His experience spans a broad range of industries, including airlines, municipalities, health care, retail, real estate, food, financial services, energy, telecommunications, entertainment, manufacturing and shipping. Mr. Kohn has been involved in virtually every major municipal restructuring in recent memory, both in and out of court, including the chapter 9 cases of Detroit and Jefferson County, Ala. In addition, he has represented major creditors in out-of-court restructurings of municipalities, including municipal debt issued by Harrisburg, Pa., Scranton, Pa., Atlantic City, N.J., and Hartford, Conn. Mr. Kohn has authored numerous articles and is a frequent panelist on issues relating to municipal restructurings. Prior to becoming a lawyer, he was a Certified Public Accountant in the State of New York and founded and managed his own accounting firm. Mr. Kohn received his B.A. from City University of New York, Queens College and his J.D. *cum laude* from Brooklyn Law School.

David M. Posner is the co-leader of Kilpatrick Townsend & Stockton LLP's Bankruptcy & Financial Restructuring Team in New York. He focuses his practice on bankruptcy and insolvency matters, and represents companies, creditors' committees, chapter 11 trustees, acquirers, financial institutions, and other significant parties-in-interest in complex reorganizations and financially distressed situations, as well as debtor/creditor rights and commercial litigation. In addition, he has substantial litigation experience representing both plaintiffs and defendants in complex commercial litigation inside the context of complex reorganization cases, and in state and federal courts across the country. Mr. Posner has been involved in all aspects of pre-trial proceedings, preliminary injunction hearings, motion practice, applications, mediation, objections and other contested matters. He has tried both jury and

non-jury trials in bankruptcy, state and federal courts. Prior to joining the firm, Mr. Posner was a member of the Insolvency and Creditors' Rights group of a New York City law firm, where he represented creditors' committees in chapter 11 reorganization proceedings, commercial corporations and financial institutions as both secured and unsecured creditors in chapter 11 reorganization proceedings, and in litigations pending before federal courts. Mr. Posner is listed in the 2021, 2022 and 20223 editions of *Chambers USA: America's Leading Lawyers for Business* in the area of Bankruptcy/ Restructuring. In addition, he was recognized by *The Best Lawyers in America*® in 2021 and 2022 for Bankruptcy Litigation and again in 2023 and 2024 for Bankruptcy and Creditor/Debtor Rights/ Insolvency and Reorganization Law and Bankruptcy Litigation. He also was recognized as a *New York Metro Super Lawyer* in the area of Business Bankruptcy in 2023 and the six years immediately preceding by *Super Lawyers* magazine. Mr. Posner received his B.A. *magna cum laude* in political science and philosophy from Syracuse University in 1984 and his J.D. *cum laude* in 1988 from Syracuse University College of Law, where he was senior editor of the *Syracuse Law Review*.