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Rocky Mountain Bankruptcy Conference

# Early Edition with Bill Rochelle


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**Hon. Kimberley H. Tyson**
U.S. Bankruptcy Court (D. Colo.) | Denver


PLENARY SESSION

2024

# Big Stuff from the Supreme Court on Down

**Rocky Mountain Bankruptcy Conference**

**June 13, 2024; 7:45 A.M.**

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**Hon. Michael E. Romero**
**Hon. Kimberley H. Tyson**
**Hon. Kevin R. Anderson**
**Hon. Cathleen A. Parker**
**Prof. Sally M. Henry**
**Bill Rochelle (ABI - Moderator)**

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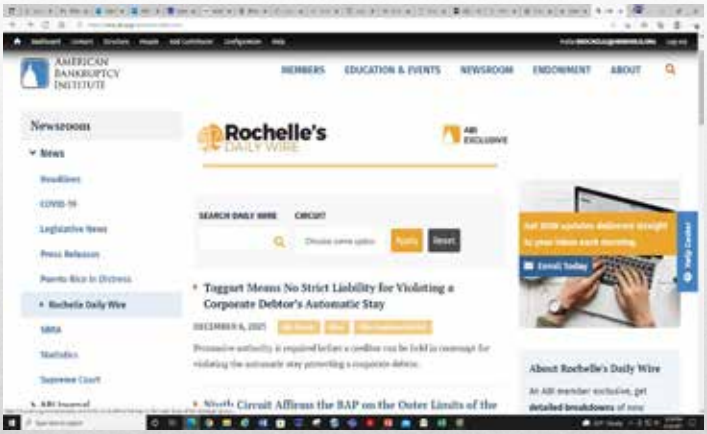


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## [name of program]
### [date and time]

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# Supreme Court


## *On the Docket for This Term*


***At oral argument, the justices were focused on whether the word "appropriate" in Section 1123(b)(6) allows chapter 11 plans to include nonconsensual, nondebtor third-party releases.***

# Supreme Court Seems Dubious About Purdue's Nonconsensual, Nondebtor Releases

At the *Purdue* oral argument yesterday in the Supreme Court, the justices focused much of their attention on the word "appropriate" in Section 1123(b)(6) and whether it permits confirmation of a chapter 11 plan that includes nonconsensual releases of creditors' direct claims against third parties who themselves are not in bankruptcy.

The justices were not unreceptive to the argument that creditors with claims related to opioid addiction may receive nothing if the Court reverses the Second Circuit and sets aside confirmation of Purdue's chapter 11 plan. To read ABI's report on the Second Circuit opinion, *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 69 F.4th (2d Cir. May 30, 2023), click here.

Tough Sledding for the Government at First

Purdue was a manufacturer of opioids. The bankruptcy court confirmed a chapter 11 plan for Purdue that included nonconsensual releases of opioid claims against the company's owners, officers and directors in return for the contribution of several billion dollars by members of the Sackler family. The district court reversed and set aside confirmation. Under longstanding authority in the circuit, the Second Circuit reversed the district court and reinstated confirmation.

On nondebtor releases, there is a split of circuits. The Fifth, Ninth and Tenth Circuits don't permit them. Like the Second Circuit, others allow them.

The U.S. Trustee sought a stay pending appeal. The Second Circuit denied a stay, but the Supreme Court granted a stay. In fact, the Court took the government's petition for a stay to be a petition for a writ of *certiorari* and granted review on August 10. To read ABI's story, click here.

As the petitioner in the Supreme Court, the U.S. Trustee argued first and was represented in the Court by the U.S. Solicitor General.

The Solicitor General received a tough but not brutal reception from the justices. The government's oral argument was based largely on the idea that the word "appropriate" in Section


1123(b)(6) does not allow nonconsensual releases of this type. The section says that a chapter 11 plan "may . . . include any other appropriate provision not inconsistent with the applicable provisions of this title."

The government contended that the nonconsensual releases were the equivalent of a bankruptcy discharge that violated two fundamental concepts of bankruptcy law: (1) To receive a discharge, individuals, like members of the Sackler family, must submit all of their assets to the bankruptcy court; and (2) the Purdue plan gave releases to the Sacklers that would insulate them from claims that would be nondischargeable were they in bankruptcy themselves.

Several justices challenged the government's opposition to the plan by alluding to how 97% of voting creditors were in favor of the plan. How or why could the government substitute its judgment for the wishes of creditors who stand to make recoveries under the plan but may never receive any compensation if confirmation is set aside?

The government received several "friendly" questions from the bench. For example, Justice Neil M. Gorsuch asked whether the releases might offend the Due Process Clause of the Fifth Amendment or the Seventh Amendment's right to a jury trial. Justice Amy Coney Barrett wondered whether it would be preferable for Congress rather than the courts to craft global solutions for mass tort cases.

Justice Ketanji Brown Jackson asked the government whether there was any precedent under the former Bankruptcy Act to permit nonconsensual releases. The Solicitor General cited *Callaway v. Benton*, 336 U.S. 132 (1949), and said that the "courts were not doing this" under the Act.

Tough Sledding for Purdue

As respondents, counsel for Purdue and the official creditors' committee argued second and third. They said that nonconsensual releases have been used successfully for 30 years and that the Court should not "disrupt longstanding practice."

Questions from the bench to the debtor and the committee were more probing.

Justice Sonia Sotomayor said that one of the government's "stronger arguments" was based on the idea that discharges are dispensed only when all of the "assets are on the table" and that affirming the Second Circuit might "subvert" one of the fundamental principles of bankruptcy law.

Much of the questioning by the justices focused on the word "appropriate" in Section 1123(b)(6). One justice said that a broad word like "appropriate" has "some limits" and should be read in the "statutory context" of the more narrow subsections (b)(1) through (b)(5).


Constitutionally speaking, a justice said that the releases raise "serious" due process and Seventh Amendment concerns and "defy" what the Court does with class actions.

The so-called major questions doctrine was also on the minds of some justices. Justice Brett M. Kavanaugh said that the Court has been "cautious" in giving broad authority to agencies on major questions. He also cited the Court's reluctance to conclude that Congress put "elephants in mouse holes."

Justice Barrett asked why Congress enacted Section 524(g) to permit nonconsensual releases in asbestos cases if the power already resided in Section 1123(b)(6).

Standing and Consensual Releases

The debtor and the committee challenged the U.S. Trustee's standing. Indeed, finding that the U.S. Trustee lacked standing might be the debtor's best hope of success.

The government said that the U.S. Trustee is the congressionally created "watchdog" over bankruptcy. In addition, the Solicitor General noted that an opioid creditor had been objecting in bankruptcy court throughout and was a petitioner in the Supreme Court.

Justice Clarence Thomas on several occasions asked why the government conceded that releases under a plan could be consensual. The questions suggested that Justice Thomas may be of the opinion that a plan may contain neither consensual nor nonconsensual releases.

Justice Sotomayor noted that a petition for *certiorari* is pending in the Supreme Court from the Fifth Circuit's decision in *In re Highland Cap. Mgmt., L.P.*, 48 F.4th 419 (5th Cir. July 28, 2023). She asked how the Court could craft an opinion disallowing nonconsensual releases without also wiping out exculpations. To read ABI's report on *Highland Capital*, click here.

Curtis E. Gannon, the Deputy Solicitor General, argued on behalf of the U.S. Trustee as petitioner. Gregory G. Garre from the Washington, D.C., office of Latham & Watkins LLP argued for the debtor, while Pratik A. Shah from the Washington, D.C., office of Akin Gump Strauss Hauer & Feld LLP argued for the creditors' committee. All are veteran appellate advocates in the Supreme Court.

The case is *Harrington v. Purdue Pharma L.P.*, No. 23-124 (Sup. Ct.).


***Several justices seemed to believe that 'prospective relief' is sufficient to remedy the due process violation because the alternatives are ineffective.***

# Supreme Court Seems Disinclined to Pay Refunds for Overpayment of U.S. Trustee Fees

The Supreme Court heard oral argument on January 9 in *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 22-1238 (Sup. Ct.), to decide whether chapter 11 debtors are entitled to refunds for overpayment of fees for the U.S. Trustee system that the Court unanimously found unconstitutional in *Siegel v. Fitzgerald*, 142 S. Ct. 1770 (Sup. Ct. June 6, 2022).

Several justices were quiescent at oral argument. Those who spoke seemed skeptical about the idea that the remedy for a due process violation requires refunds to those who paid too much. The theory for no retrospective remedy is this: Compelling the payment of higher fees from those who underpaid is largely impossible, and refunds won't go to everyone who overpaid.

As Justice Ketanji Brown Jackson said late in the argument, "If it's hard to do or impossible to do, then we can just go prospective," by which she meant to say that payments going forward must be uniform throughout the country in both U.S. Trustee and Bankruptcy Administrator districts.

Justice Jackson was the most active questioner. Don't be surprised if she's the author of *Hammons Fall*.

*Siegel*

*Siegel* came to the Supreme Court because the circuits were split on whether the 2018 increase in payments to the U.S. Trustee system was unconstitutional because it was not immediately applicable in the two states with Bankruptcy Administrators rather than U.S. Trustees. For the unanimous Court, Justice Sonia Sotomayor held that the lack of uniformity violated the Bankruptcy Clause of the Constitution. To read ABI's report on *Siegel*, click here.

In *Siegel*, the Court explicitly left open the question of remedy. In lawsuits around the country, debtors who paid too much were asking for refunds. The government contended that prospective relief was sufficient. In other words, the government believes it is enough for the Court to have ruled that fees must be uniform throughout the country in the future.


Uniformly, the government lost. Four circuits required refunds for overpayments. Despite the lack of a circuit split, the Solicitor General filed a petition for *certiorari* on behalf of the government. On September 29, the Court granted the petition and agreed to hear the government's appeal.

The outcome in *Hammons Fall* has significance beyond the handful of debtors that have sued for refunds. In a class action pending in the Court of Federal Claims in Washington, D.C., the plaintiff wants refunds for debtors nationwide who paid too much. *See Acadiana Management Group LLC v. U.S.*, 19-496 (Ct. Cl.).

The Government's Argument

As petitioner, the government argued first via Assistant Solicitor General Marsha G. Hansford. She said that refunds would cost the government $326 million, even though those debtors paid "exactly what Congress intended." Throughout, the government harped on the idea that Congress has always intended for the U.S. Trustee system to fund itself with assessments on chapter 11 debtors and without assistance from taxpayers.

Every justice who addressed the issue seemed to agree that Congress meant for the system to be self-funding.

If the due process violation requires a retrospective remedy, the government argued that "leveling up" was the proper remedy. In other words, the government said that the Court should order the 48 debtors in the two states to pay the higher fees amounting to $3.8 million. Once the government moves to collect from debtors in the two states, the Solicitor General said that the debtors in 48 states who paid too much "would be made entirely whole."

Justice Sotomayor was skeptical. She said that the idea of a "clawback" from those who underpaid "doesn't seem quite right."

If retrospective relief is required, Justice Amy Coney Barrett said that the question is whether to require a "level up" or "level down." In other words, should there be leveling down by paying refunds, or leveling up by asking for payments from debtors in the two states who paid too little?

Justice Barrett saw more practical problems with leveling down, because 2,100 debtors would be entitled to refunds, while leveling up would ask for payments from only 48 debtors. She said that "practical problems are actually much worse with a refund remedy."

If leveling up were required, Justice Neil M. Gorsuch had difficulty envisioning the remedy. Would the Court order the Judicial Conference to pursue underpayments? However, he observed that the Judicial Conference was not a party to the case.


Furthermore, Justice Gorsuch said that leveling up would demand payments from some debtors whose cases are closed. "I just haven't heard of anything like that before," he said twice.

In response to questions by Justice Jackson, the government said that the preferred remedy is no remedy at all. In other words, the government believes that the Court rectified the constitutional violation by demanding that payments henceforth must be uniform in U.S. Trustee and Bankruptcy Administrator districts.

The Solicitor General said that Congress intended to collect an additional $330 million by raising the fees in 2018 and had succeeded in collecting $326 million. Ms. Hansford said that there were underpayments in only 2% of cases, representing a shortfall of just 1% in payments.

The government believes that a prospective-only remedy satisfies due process requirements because debtors at the time had a "pre-deprivation" remedy where they could have withheld payments, escrowed payments or sued the U.S. Trustee.

The Debtor's Argument for a Refund

Daniel L. Geyser from the Dallas office of Haynes & Boone LLP took up the cudgels for the debtor seeking a refund. He contended that "prospective-only relief is insufficient to address a past monetary injury." He said there was no pre-deprivation remedy that was both "clear and certain."

Justice Clarence Thomas seemed skeptical about the idea that there was no pre-deprivation remedy. In the same vein, Justice Sotomayor said, "Nobody stopped you from getting prospective relief."

Justice Jackson prevailed on the debtor to concede that Congress intended for all debtors to pay the higher fees. She "didn't see anything in the legislative history" to suggest that Congress would want refunds.

Focusing on the idea that Congress wants the system to be self-funding, Justice Elena Kagan said there was a "pretty strong case" that the remedy should be collection from debtors who underpaid.

Among debtors who underpaid, Justice Sotomayor said that "10 big companies are still in bankruptcy" and that recoveries from them would cover 31% of all underpayments. On "bad debt," she said, 31% would be a "great recovery."

Justice Kavanaugh observed that "there's not going to be perfection" because "the refunds will not get to everyone" and underpayments can't be recovered from every debtor in the two states. He also said that requiring $326 million in refunds "would be inconsistent with the usual principle that bankruptcy pays for itself."


To the same effect, Justice Kagan said, "Everything we know about Congress not wanting to impose bankruptcy costs on taxpayers suggests that if it's at all possible, it should be done by collection."

Near the end of the hour's argument, Justice Jackson noted how both leveling up and leveling down appeared impossible. "If it's hard to do or impossible to do, then we can just go prospective," she said.

To read the transcript of oral argument, click here. To read the transcript, click here.

Observations

For chapter 11 debtors hoping for refunds, all is not lost. For the debtor, oral argument also didn't go well in *Siegel*.

Arguably, ruling for the government would create a conflict with three or four Supreme Court precedents and upset the assumption that constitutional violations will be addressed with meaningful relief, not precatory proclamations alone.

If the Court decides in *Hammons Fall* that no monetary relief is required to remedy the constitutional violation, the door will open for violators in the future to contend that retrospective relief isn't required when relief is difficult to fashion. Without assurance of monetary relief, plaintiffs will be disinclined to pursue constitutional violations, and the Constitution won't be rigorously enforced.

One potentially significant fact was not raised at argument. In the *Acadiana* class action, the plaintiff is asking for payment from the federal Judgment Fund pursuant to 28 USC § 2517 and 31 USC § 1304, not from the resources of the U.S. Trustee system. If the Judgment Fund provides refunds, the U.S. Trustee system would not lose $326 million, alleviating concern about thrusting the cost of bankruptcy onto the taxpayer.

Furthermore, the U.S. Trustee did not cause the constitutional violation. The violation resulted from a faulty act of Congress, suggesting that the cost of relief should be imposed on the federal government generally.

The government should not be shielded from the consequences of its own misdeeds by hiding behind the idea that the U.S. Trustee system should pay refunds, when the U.S. Trustee system did not cause the problem in the first place.

For the Solicitor General, Marsha Hansford made the best argument this writer has heard in the Supreme Court. She answered difficult questions instantly, in complete sentences and complete


paragraphs. It seemed as though she had anticipated and memorized answers to every question thrown her way.

The case is *Office of the U.S. Trustee v. John Q. Hammons Fall 2006 LLC*, 22-1238 (Sup. Ct.).


***The Supreme Court may decide that standing in bankruptcy cases is more flexible and that Article III standards don't apply in chapter 11 cases.***

# Supreme Court Hears Argument on Who Has Standing in Bankruptcy Cases

The Supreme Court heard oral argument on March 19 in *Truck Ins. Exch. v. Kaiser Gypsum Co.*, the third bankruptcy case of the term. To resolve a split of circuits, the high court will decide whether any creditor or "party in interest" may object to confirmation of a chapter 11 plan, even if the creditor has no financial stake underpinning the objection.

In other words, may creditors object to provisions in plans that do not affect them?

As usual, the outcome is impossible to determine based on the justices' questions from the bench. It appears to this writer that the justices were struggling with several questions:

(1) Are Article III standards for constitutional standing applicable in chapter 11 cases?

(2) In a bankruptcy case, is standing established on filing, or sometime later in the case?

(3) Can a creditor with standing at the outset lose standing later in the case?

(4) Is standing as defined in Section 1109(b) coterminous with constitutional standing?

(5) Can Section 1109(b) be unconstitutional as applied if the section grants standing to someone who does not have constitutional standing?

(6) Do creditors and other "parties in interest" under Section 1109(b) have standing throughout the case to object to anything, even issues that do not affect them financially?

The justices recognized that bankruptcy cases are different from ordinary civil litigation, where principles of constitutional standing were developed. When deciding whether an order from a bankruptcy court is final and appealable, the Court developed a flexible approach.

Will the justices adopt a similarly flexible approach in fashioning standing requirements for bankruptcy cases? Or, are bankruptcy cases inflexibly bound by traditional Article III "case or controversy" standards?


However the Court rules about standing in chapter 11 cases, will the same rules apply in cases under chapters 7, 12 and 13, where Section 1109(b) is not applicable?

The Chapter 11 Plan Was 'Insurance Neutral'

For a more thorough discussion of the facts in *Truck Insurance*, click here to read the ABI story published when the Court granted *certiorari*.

Briefly, the debtor's "asbestos" chapter 11 plan was "insurance neutral." That is, the plan preserved all of the rights that the insurer, Truck Insurance, held under the insurance policies it had issued before bankruptcy. The insurance company nonetheless objected to confirmation because it wanted the plan to include additional protections warding off fraudulent claims.

The Fourth Circuit held that the insurer had standing to contest the finding of insurance neutrality. Once the appeals court decided that the plan indeed was insurance neutral, the Fourth Circuit decided that the insurer had no standing to object to other features of the plan because its contractual rights were not affected. *Truck Insurance Exchange v. Kaiser Gypsum Co. (In re Kaiser Gypsum Co.)*, 60 F.4th 73 (4th Cir. Feb. 14, 2023), *cert. granted sub nom. Truck Ins. Exch. v. Kaiser Gypsum Co.*, No. 22-1079 (Oct. 13, 2023). To read ABI's report on the Fourth Circuit's decision, click here.

To be handed down before the end of the term in late June, the decision by the Supreme Court revolves around Section 1109(b), which says:

> *A party in interest, including* the debtor, the trustee, a creditors' committee, an equity security holders' committee, *a creditor*, an equity security holder, or any indenture trustee, *may raise and may appear and be heard on any issue in a case under this chapter*. [Emphasis added.]

Apart from Section 1109(b), a litigant typically establishes Article III or constitutional standing by showing (1) an injury in fact that is concrete, particularized and actual or imminent; (2) an injury fairly traceable to the defendant's conduct; and (3) an injury that can be addressed by a favorable decision. In many chapter 11 cases with deeply insolvent debtors, shareholders or subordinated creditors might not be able to show Article III standing.

As a matter of statutory interpretation, did Congress mean that a "party in interest" in Section 1109(b) also must have constitutional standing? Did Congress intend by Section 1109(b) to broaden standing in chapter 11 cases beyond parties with constitutional standing? Does Congress have the right to expand standing in bankruptcy cases beyond that which Article III permits? Does constitutional standing even *apply* in bankruptcy cases?


Lastly, does a deeply subordinated creditor or a shareholder have standing when the debtor is so insolvent that nothing under the plan will go in the direction of shareholders or deeply subordinated creditors?

Oral Argument

Arguing first, the insurance company took the position that anyone at the outset of the case who falls within one of the categories in Section 1109(b) will have standing throughout. Several justices were skeptical, suggesting that someone not a "party in interest" at the outset might gain standing by occurrences taking place later.

Early in argument, Chief Justice John G. Roberts, Jr. asked how the insurance company could have an interest in who receives policy proceeds, when it was clear that the insurer would receive none of the proceeds. He also asked whether "party in interest" is "the same test for Article III?"

Justice Sonia Sotomayor was searching for a loophole to expand standing in chapter 11 cases beyond parties with constitutional standing. Because the bankruptcy court is an Article I court and a bankruptcy case is akin to an administrative proceeding, was Congress free to enact broader standing?

In contrast, Justice Ketanji Brown Jackson worried about an expansive notion of standing. She seemed concerned that one of a debtor's competitors could have standing under a broad interpretation of standing, even though the competitor was not a creditor.

Justice Neil M. Gorsuch wondered whether Article III even applies in bankruptcy. In ordinary civil litigation, he said that the plaintiff alone must show standing. If creditors are similar to defendants who aren't required to show standing, perhaps creditors always have standing.

Justices Sotomayor and Elena Kagan both questioned how the constitutional standard of "directly and adversely affected" applies to standing in bankruptcy cases. Justice Kagan seemed to think that a party might have interests in a bankruptcy case beyond its own pecuniary interests.

Even though the insurer's contractual interests were not impaired by the plan, Justice Kagan seemed to believe that the insurer might have standing because the insurer wanted the plan to improve its financial situation. In a somewhat similar vein, Justice Gorsuch said he was "struggling" with the question of why the insurer could not be heard to object to the plan.

The appeal is *Truck Ins. Exch. v. Kaiser Gypsum Co.*, 22-1079 (Sup. Ct.).


***The unanimous decision on March 19 by Justice Gorsuch contains language that could be used on both sides of the argument about the validity of equitable mootness.***

# Supreme Court Rules on Mootness, but Not Equitable Mootness

In the world of bankruptcy, the validity of the doctrine of equitable mootness is an issue that the Supreme Court has been ducking. On March 19, the Court handed down a non-bankruptcy decision on constitutional mootness. Although the unanimous decision by Justice Neil M. Gorsuch includes quotations that could be employed on both sides of the argument, the opinion doesn't give a solid clue on how the justices would rule on the validity of equitable mootness.

Equitable mootness is not a product of Article III's requirement that there must be a case or controversy. When equitable mootness is invoked to dismiss an appeal, there typically is an extant case or controversy.

Not based on the Constitution, equitable mootness is a prudential doctrine — that is, something invented by courts. Most often, equitable mootness is invoked to dismiss an appeal from an order confirming a chapter 11 plan.

Although the circuits are not uniform in their application of the doctrine, three factors usually resulting in a finding of equitable mootness are the lack of a stay pending appeal, substantial consummation of the plan and an adverse effect on parties not before the court on appeal.

## The 'No-Fly' List

The individual in the case before the Supreme Court was born in Eritrea and lived in Sudan before his family moved to the U.S., where he became a citizen. As an adult, he traveled to Sudan on business.

While in Sudan, he was told by U.S. officials that he was on the no-fly list and could not return to the U.S. While still abroad some years later, he sued the U.S. government, claiming a due process violation for having no notice about the basis for his classification and no method to secure redress.


Soon after the suit was filed, the government removed him from the no-fly list and then moved to dismiss the suit as moot. In support of dismissal, the government said that he would not be placed on the no-fly list in the future "based on currently available information."

The district court twice dismissed the case as moot, but the Ninth Circuit twice reversed, not seeing the case as moot. To resolve a circuit split, the Supreme Court granted the government's petition for *certiorari*.

The Merits

When there is a case or controversy as Article III requires, Justice Gorsuch cited Supreme Court precedent for saying that federal courts have a "virtually unflagging obligation" to hear the case. "But," he said, "events in the world overtake those in the courtroom, [when] a complaining party manages to secure outside of litigation all the relief he might have won in it."

"When that happens," Justice Gorsuch said, "a federal court must dismiss the case as moot." He added, "federal judges are not counselors or academics; they are not free to take up hypothetical questions that pique a party's curiosity or their own."

Of possible application to the bankruptcy world, Justice Gorsuch said:

> The limited authority vested in federal courts to decide cases and controversies means that they may no more pronounce on past actions that do not have any "continuing effect" in the world than they may shirk decision on those that do.

Justice Gorsuch went on to say:

> [O]ur precedents hold [that] a defendant's "'voluntary cessation of a challenged practice'" will moot a case only if the defendant can show that the practice cannot "'reasonably be expected to recur.'" [Citations omitted.]

Also of possible application to equitable mootness, Justice Gorsuch said, "a defendant might suspend its challenged conduct after being sued, win dismissal, and later pick up where it left off," were it easier to show mootness.

Affirming the circuit court, Justice Gorsuch decided that the case was not moot because the government's statement only referred to reliance on actions taken in the past. "[N]one of that," he said, "speaks to whether the government might relist him if he does the same or similar things in the future."

"In all cases," Justice Gorsuch said, "it is the defendant's 'burden to establish' that it cannot reasonably be expected to resume its challenged conduct."


Observations

The opinion by Justice Gorsuch is founded on the notion that a case is not moot if the defendant can take the challenged action again in the future. In the bankruptcy sphere, cases found to be equitably moot usually deal with legal questions that are likely to recur in other cases.

Perhaps fatally so, the Supreme Court's decision is distinguishable because the same creditor in a bankruptcy case would not be raising the same question in the future against the same debtor.

The question is this: Does the Supreme Court's focus on the ability of someone to raise the same issue suggest that the high court would frown on equitable mootness regarding a question that's endemic in bankruptcy cases?

The opinion is *F.B.I v. Fikre*, 22-1178 (Sup. Ct. March 19, 2024).


***The Supreme Court again retreated from the idea that there's a strong federal policy in favor of arbitration.***

# Supreme Court Ruled Again on Arbitration, but Not (Yet) in Bankruptcy Cases

When the Supreme Court writes an opinion on arbitration, we pay attention because the high court will decide, one of these days, whether or when arbitration agreements are enforceable in bankruptcy.

Will the Supreme Court say that arbitration is always enforceable? (Unlikely.) Or, will arbitration never be enforceable in bankruptcy? (Also unlikely.)

What's the dividing line? Will arbitration be enforceable if the dispute is noncore but unenforceable if it's core?

Once there's a final order, bankruptcy disputes are appealable. Will the lack of appeal from an arbitration award factor into the question about enforceability of arbitration agreements in bankruptcy cases?

And finally, will arbitration agreements be enforceable against a debtor in possession but not against a trustee, because a trustee will not have been a party to the arbitration agreement?

If anything, the latest arbitration decision from the Supreme Court on April 12 implies a broader interpretation of exceptions to arbitration.

## The Employer Was a Commercial Bakery

The case involved one of the country's largest commercial bakeries. Two individuals were local distributors for the bakery, which had plants in 19 states and distribution throughout the country.

The bakery delivered baked goods to a warehouse, where they were picked up by the distributors and sold to retailers in the state. In a purported class action, the distributors sued the bakery in federal district court for violations of federal labor laws.

The distributorship agreement had a clause saying that "any claim" must be arbitrated. The bakery filed a motion to compel arbitration. The outcome turned on an exception to arbitration contained in the Federal Arbitration Act, 9 U.S.C. § 1. The section says that "nothing herein


contained shall apply to contracts of employment of seamen, railroad employees, *or any other class of workers engaged in foreign or interstate commerce.*" [Emphasis added.]

The district court granted the motion to compel arbitration and was upheld in the Second Circuit, over dissent. According to the unanimous, nine-page opinion by Chief Justice John G. Roberts, Jr., the majority on the Second Circuit reasoned that the bakery was in the baking business, not in the transportation business, making the exception inapplicable.

The Supreme Court granted *certiorari* to resolve a split with the First Circuit.

Focus on the Employee, Not the Employer

Justice Roberts surveyed the Supreme Court's more recent authorities on arbitration, noting how the Court had ruled in 2001 that the exception in Section 1 "is limited to transportation workers." *Circuit City Stores Inc. v. Adams*, 532 U.S. 105 (2001). Later, the Court said that the exception applies to workers who are "engaged" in commerce and does not turn on the industry of the employer.

The relevant question, Justice Roberts said, asks what the employee does for the employer, not what the employer does. Thus, he said, "A transportation worker need not work in the transportation industry to fall within the exemption from the FAA provided by § 1 of the Act."

The Chief Justice ruled that the Second Circuit "erred in compelling arbitration on the basis that petitioners work in the bakery industry." He vacated the judgment of the Second Circuit and remanded for further proceedings, expressing "no opinion on any alternative grounds in favor of arbitration raised below, including that petitioners are not transportation workers . . . ."

Observation

The opinion is another example showing the Supreme Court's retreat from the idea that there is a strong federal policy in favor of arbitration.

As Justice Elena Kagan said in May 2022, "The policy is to make 'arbitration agreements as enforceable as other contracts, but not more so.' *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404, n. 12 (1967)." *Morgan v. Sundance Inc.*, 596 U.S. 411, 42 S. Ct. 1708, 1713 (Sup. Ct. May 23, 2022). To read ABI's report, click here.

In bankruptcy, keep in mind that contracts are not enforceable in all respects. Similarly, forum-selection clauses largely yield to the Bankruptcy Code.

If arbitration agreements are enforceable like any other contract in bankruptcy, perhaps arbitration clauses are only enforceable when a debtor is suing someone who has not filed a proof


of claim or otherwise submitted to jurisdiction. Perhaps courts will say that an arbitration agreement by a debtor does not bind a trustee because the trustee did not sign the arbitration agreement.

The opinion is *Bissonnette v. LePage Bakeries Park St. LLC*, 23-51 (Sup. Ct. April 1, 2024).


## *Last Term*


ROCHELLE'S DAILY WIRE


***The opinion by Justice Barrett largely bases the outcome on the use of the passive voice in Section 523(a)(2)(A).***

## Debts for a Partner's Fraud Are Still Nondischargeable, the Supreme Court Says

Based on the "natural breadth of the passive voice" used in Section 523(a)(2)(A), the Supreme Court held yesterday in a unanimous opinion by Justice Amy Coney Barrett that a partner who herself was innocent of fraud is nonetheless saddled with a nondischargeable debt resulting from the fraud of her partner.

The opinion is a reaffirmation of the Court's holding in *Strang v. Bradner*, 114 U.S. 555 (1885).

In a concurring opinion, Justices Sonia Sotomayor and Ketanji Brown Jackson endeavored to limit the scope of the holding by saying that they understood the outcome to be based on the existence of a partnership under state law.

The Partner's Fraud

Before marrying, a couple formed a partnership to buy, refurbish and sell a home. Judge Barrett said the woman was "largely uninvolved" in the remodel and sale.

Alleging that the disclosure statement failed to list defects in the home, the buyer filed suit after purchasing the home. A jury found the man and woman liable for $200,000 in damages for breach of contract, negligence and nondisclosure of material facts.

The couple filed a chapter 7 petition. The buyer filed an adversary proceeding contending that the judgment was nondischargeable under Section 523(a)(2)(A) as a debt resulting from "false pretenses, a false representation, or actual fraud." After a bench trial, the bankruptcy court ruled that the debt was nondischargeable as to both.

The Bankruptcy Appellate Panel for the Ninth Circuit reversed as to the woman, saying she had no reason to know of the man's fraudulent intent. Relying on *Strang*, the Ninth Circuit reversed the BAP, reinstating the nondischargeability judgment with respect to the woman. According to Justice Barrett, the Court of Appeals reasoned that "a debtor who is liable for her partner's fraud cannot discharge that debt in bankruptcy, regardless of her own culpability."


The woman filed a petition for *certiorari*, which the Court granted to resolve a split among the circuits. The Second, Fourth, Seventh and Eighth Circuits require scienter before the debt is deemed nondischargeable, while the Fifth, Sixth, Ninth and Eleventh Circuits don't.

An Opinion Based on Grammar

Judge Barrett held that the "text" of Section 523(a)(2)(A) barred the woman from discharging the debt "[b]y its terms." Based on the "basic tenets of grammar," she said that the statute's use of the "[p]assive voice pulls the actor off the stage."

Although the debt must result from fraud, Justice Barrett said that "Congress was 'agnosti[c]' about who committed it. *Watson v. United States*, 552 U.S. 74, 81 (2007)." The "context" of the statute, she said, "does not single out the wrongdoer as the relevant actor."

Justice Barrett said that "the common law of fraud . . . has long maintained that fraud liability is not limited to the wrongdoer." Citing a commentator from 1841 and state supreme court decisions from the nineteenth century, she listed courts that "have traditionally held principals liable for the frauds of their agents."

The debtor contended that the interpretation of Section 523(a)(2)(A) should be informed by subsections (B) and (C), which require a culpable act by the debtor. Justice Barrett rejected the argument, saying that the "more likely inference is that (A) excludes debtor culpability from consideration given that (B) and (C) expressly hinge on it."

The Court's Precedent

"Our precedent," Justice Barrett said, "eliminates any possible doubt about our textual analysis."

At the time of *Strang*, the statute required fraud "of the bankrupt." Nonetheless, the Court held in *Strang* that the "fraud of one partner . . . is the fraud of all because '[e]ach partner was the agent and representative of the firm with reference to all business within the scope of the partnership.'" *Strang*, *supra*, 114 U.S. at 561.

Thirteen years after *Strang*, Justice Barrett said that Congress "overhauled the bankruptcy law," this time deleting "'of the bankrupt' from the discharge exception for fraud, which is the predecessor to the modern § 523(a)(2)(A)."

"The unmistakable implication," Justice Barrett said, "is that Congress embraced *Strang*'s holding — so we do too."


Justice Barrett ended her opinion for the Court by saying she was "sensitive to the hardship that the debtor faces," but she went on to say that "innocent people are sometimes held liable for fraud they did not personally commit, and, if they declare bankruptcy, § 523(a)(2)(A) bars discharge of that debt."

The Court affirmed the Ninth Circuit's judgment that the debt was nondischargeable.

The Concurrence

Joined by Justice Jackson, Justice Sotomayor concurred, saying that the "Court correctly holds that 11 U.S.C. § 523(a)(2)(A) bars debtors from discharging a debt obtained by fraud of the debtor's agent or partner." Citing *Strang*, she said that the "Court long ago confirmed that reading when it held that fraudulent debts obtained by partners are not dischargeable."

Justice Sotomayor noted that the woman and her husband incurred the debt after forming a partnership. She said that the "Court here does not confront a situation involving fraud by a person bearing no agency or partnership relationship to the debtor."

She joined the Court's opinion with the "understanding" that it concerns fraud only by "agents" and "partners within the scope of the partnership."

Application to Section 523(a)(19)

Justice Sotomayor's understanding of the opinion, if adopted by other courts, may affect the application of Section 523(a)(19). That subsection bars the discharge of judgments by state or federal courts for violation of state or federal securities laws, but it too is in the passive voice and does not in its language demand a violation committed by the debtor.

Presumably, a court influenced by Justice Sotomayor's concurrence would make a debt nondischargeable as to an innocent debtor only if there were an agency or partnership.

Observations

Justice Barrett rejected the debtor's reliance on *Bullock* v. *BankChampaign, N. A.*, 569 U.S. 267 (2013). There, the Court held that under Section 523(a)(4) the term "defalcation"

> includes a culpable state of mind requirement akin to that which accompanies application of the other terms in the same statutory phrase. We describe that state of mind as one involving knowledge of, or gross recklessness in respect to, the improper nature of the relevant fiduciary behavior.

*Id*. at 269.


*Bullock* means that defalcation cannot be derivative, but the Court yesterday held that a fraudulent representation or actual fraud can be derivative.

Curiously, *Strang* cited and discussed *Neal v. Clark*, 95 U.S. 709 (1877). The *Strang* court paraphrased *Neal* as saying that

> the term "fraud," in the clause defining the debts from which a bankrupt is not relieved by a discharge under the bankrupt act, should be construed to mean positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, and not implied fraud or fraud in law, which may exist without the imputation of bad faith or immorality.

*Neal* required "positive fraud, or fraud in fact," but the Court yesterday imposed nondischargeability when the debt was derived from someone else's fraud.

With respect, this writer sees the Court as being selective in citing nineteenth century precedent for the idea that innocent individuals can be saddled with nondischargeable debts.

True, common law for centuries has held that one partner is liable for another partner's fraud, but nondischargeability and derivative liability for fraud are different questions under a different statute.

However, Congress adopted Section 523(a)(2)(A), presumably knowing what *Strang* says. Still, this writer is troubled by the notion that contemporary courts are so bound by nineteenth century precedent.

The opinion is *Bartenwerfer v. Buckley*, 143 S. Ct. 665, 214 L. Ed. 2d 434 (Sup. Ct. Feb. 22, 2023).


***The Supreme Court's MOAC decision contains language casting doubt on the validity of the doctrine of equitable mootness.***

# Supreme Court Holds: § 363(m) Isn't Jurisdictional; It's a Limitation on Appellate Relief

Reversing the Second Circuit, the Supreme Court handed down a unanimous opinion today in *MOAC Mall Holdings LLC*, deciding that Section 363(m) is not jurisdictional. It's a limitation on the remedy available to an appellate court on an appeal from an order approving a sale.

Section 363(m) says that the reversal or modification "of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease [to a purchaser in good faith] . . . unless such authorization and such sale or lease were stayed pending appeal."

The Second and Fifth Circuits have held that Section 363(m) is jurisdictional. The Third, Sixth, Seventh, Ninth, Tenth and Eleventh Circuits have held that it is not. The opinion for the Court by Justice Ketanji Brown Jackson was her first since her elevation in June 2022.

The Sale of a Sears Lease

The petitioner in the Supreme Court was the landlord of a Sears store in the giant Mall of America. The landlord objected to the assignment of a lease but lost in bankruptcy court.

Initially, the district court reversed the bankruptcy court, holding that a provision in a lease cannot supplant the requirement in Section 365(b)(3)(A) mandating that the financial condition of an assignee of a lease must be "similar to the financial condition . . . of the debtor . . . as of the time the debtor became the lessee under the lease . . . ." *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 613 B.R. 51 (S.D.N.Y. May 11, 2020). ("*MOAC I*"). To read ABI's report on *MOAC I*, click here.

Two weeks later, the purchaser of the lease filed a motion for rehearing. Although having taken contrary positions throughout, the purchaser contended for the first time on rehearing that the appeal should be dismissed under Section 363(m) because the landlord had not obtained a stay pending appeal. Previously, the purchaser had consistently contended that the transaction was not a sale and that Section 363 did not apply.


Ruling on the motion for rehearing, the district judge said that the buyer now "seeks to benefit from a complete reversal of that representation." *MOAC II*, 616 B.R. at 626. Citing *In re WestPoint Stevens Inc.*, 600 F.3d 231, 248 (2d Cir. 2010), and *In re Gucci*, 105 F.3d 837, 838–840 (2d Cir. 1997), the district judge said that the Second Circuit had twice held that Section 363(m) is "a jurisdiction-depriving statute." *Id*. at 624.

In *MOAC II*, the district judge granted rehearing, concluded that she lacked appellate jurisdiction, vacated her earlier opinion, and dismissed the appeal. The Second Circuit affirmed in a nonprecedential opinion. *MOAC Mall Holdings LLC v. Transform Holdco LLC (In re Sears Holdings Corp.)*, 20-1846, 2021 BL 481940, 2021 US App Lexis 37358, 2021 WL 5986997 (2d Cir. Dec. 17, 2021). To read ABI's report on the Second Circuit opinion, click here.

The circuit panel said that the landlord's argument "is foreclosed by our binding precedent in *In re WestPoint Stevens Inc.*, under which § 363(m) deprived the District Court of appellate jurisdiction." In another nonprecedential opinion citing *WestPoint Stevens*, a Second Circuit panel indeed had said that Section 363(m) is jurisdictional because it "creates a rule of statutory mootness." *Pursuit Holdings (NY) LLC v. Piazza (In re Pursuit Holdings (NY) LLC),* 845 Fed. App'x 60, 62 (2d Cir. 2021).

The landlord filed a petition for *certiorari* in March 2022, raising the circuit split. The Court granted the petition at the end of the last term in June 2022.

Jurisdiction Must Be 'Clearly Stated'

Addressing the merits, Justice Jackson rejected the buyer's "creative arguments" and mirrored comments from the district court when she referred to the buyer's conduct as "egregious" in waiting until rehearing in district court to raise the question of jurisdiction.

Justice Jackson's opinion is another stab at repairing the Court's precedents on jurisdiction versus power. She referred to "our past sometimes loose use of the word 'jurisdiction.'" More recently, she said, "We have clarified that jurisdictional rules pertain to 'the power of the court rather than to the rights or obligations of the parties.'"

Today, Justice Jackson said, "we only treat a provision as jurisdictional if Congress 'clearly states' as much," citing *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493, 1494 (2022). On the other hand, Congress isn't required to use "magic words," she said.

To be jurisdictional, Justice Jackson said that "the statement must indeed be clear; it is insufficient that a jurisdictional reading is 'plausible,' or even 'better,' than nonjurisdictional alternatives," again citing *Boechler*.


Applying precedent, Justice Jackson saw "nothing" in Section 363(m) "that purports to 'gover[n] a court's adjudicatory capacity,'" quoting *Henderson v. Shinseki*, 562 U.S. 428, 435 (2011). To the contrary, she said that "§ 363(m) takes as a given the exercise of judicial power over any authorization under § 363(b) or § 363(c)."

The section, Justice Jackson said, "consists of a caveated constraint on the effect of a reversal or modification" and "is not the stuff of which clear statements are made."

Noting that Section 363(m) is not located in 28 U.S.C. § 1334(a)-(b), (e) and § 157, Justice Jackson said, "Statutory context leads to the same conclusion" that Section 363(m) is not jurisdictional. She said that the buyer "does not (because it cannot) deny the paucity of textual or contextual clues indicating a clear statement of jurisdictional intent."

Justice Jackson said that Section 363(m) is "a mere restriction on the effects of a valid exercise of [appellate] power when a party successfully appeals a covered authorization."

Commentary on Equitable Mootness?

The buyer argued in the Supreme Court that the appeal was moot even without regard to Section 363(m). Justice Jackson rejected the argument using words that might be read as undercutting the validity of the doctrine of equitable mootness, which is the topic of a pending petition for *certiorari*. *See U.S. Bank N.A. v. Windstream Holdings Inc.*, 22-926 (Sup. Ct.).

Without relying on Section 363(m), the buyer argued that the appeal was moot because the transfer of the lease could not now be avoided as a post-petition transaction under Section 549 since the debtor alone had standing to raise Section 549 and the debtor had waived any rights under that section.

In short, the buyer was saying that the appeal was moot because no relief could be granted.

Justice Jackson said that a "'case becomes moot only when it is impossible for a court to grant any effectual relief whatever to the prevailing party,'" quoting *Chafin v. Chafin*, 568 U.S. 165, 172 (2013). "The case remains live," she said, "'[a]s long as the parties have a concrete interest, however small, in the outcome of the litigation.'" *Id.*

In the MOAC appeal, Justice Jackson said, "[W]e cannot say that the parties have 'no "concrete interest,'" *id.* at 176, in whether [the buyer] obtains that relief."

As a court of "first review," Justice Jackson rejected the mootness contention, saying, "[W]e decline to act as a court of 'first view,' plumbing the Code's complex depths in 'the first instance' to assure ourselves that [the buyer] is correct about its contention that no relief remains legally available."


The Court remanded the case to the Second Circuit for "further proceedings consistent with this opinion."

Observations

Today's opinion casts doubt on the doctrine of equitable mootness, where courts routinely dismiss appeals from confirmation orders where the plans have been consummated. *MOAC* could be read to mean that appellate courts should not in the first instance decide that no relief is available following reversal.

*MOAC* could be read to mean that an appellate court should hear an appeal from a confirmed plan as long as there is constitutional or Article III jurisdiction. More often than not, the appellate court will uphold confirmation and never reach the question of whether there would have been available relief had there been a reversal.

On remand from reversal of confirmation, the bankruptcy court might locate a sliver of relief for the appellant that would not upset the apple cart and undo the plan altogether. Perhaps the bankruptcy court could award attorneys' fees to the creditor who appealed confirmation and established an important principle about chapter 11 plans.

The opinion is *MOAC Mall Holdings LLC v. Transform Holdco LLC*, 22-1270 (Sup. Ct. April 19, 2023).


***The high court's ruling on the Takings Clause also seems to mean that real estate tax foreclosures can be avoided as constructively fraudulent transfers.***

# Supreme Court Holds that Real Estate Tax Foreclosures Can Violate the Takings Clause

Barely one month after oral argument, the Supreme Court unanimously resolved a split of circuits by reversing the Eighth Circuit and holding that a real estate tax foreclosure can violate the Takings Clause of the Fifth Amendment when the municipality takes title but doesn't give the owner the difference between the unpaid taxes and the value of the property.

For the Court, the opinion by Chief Justice John G. Roberts, Jr. said that "[h]istory and precedent" do not permit the state to take away a property interest protected by the Takings Clause.

$40,000 Property Taken for $15,000 in Taxes

A 94-year-old woman had owned a condominium. She went to live in a senior community but did not continue paying real estate taxes on the condominium. When some $2,300 in unpaid real estate taxes accrued along with $13,000 in interest and penalties, the municipality seized the property and sold it for $40,000. The county kept the $25,000 surplus and paid none to the former homeowner.

Conceding the validity of the foreclosure, the homeowner filed a class action under the Takings Clause, challenging the county's retention of the $25,000 surplus. The district court dismissed the suit for failure to state a claim and was affirmed last year in the Eighth Circuit. *Tyler v. Hennepin County*, 26 F.4th 789 (8th Cir. 2022).

The appeals court found no unconstitutional taking because state law recognized no property interest in the owner after the property was seized. The homeowner filed a petition for *certiorari* in May 2022.

While the *certiorari* petition was pending, the Sixth Circuit created a circuit split by holding that a real estate tax foreclosure violated the Takings Clause. *Hall v. Meisner*, 51 F.4th 185 (6th Cir. Oct. 13, 2022). The municipality in *Hall* had taken a $300,000 home in satisfaction of $22,250 in real estate taxes but refused to turn over the surplus. The Sixth Circuit denied a motion for rehearing *en banc* in January. To read ABI's report on *Hall*, click here.


The Supreme Court granted *certiorari* in January and held oral argument on April 26. To read ABI's report on argument, click here.

History and Precedent Rule the Day

The Chief Justice recited the history of real estate tax foreclosure in Minnesota. "Historically," he said, the state recognized an owner's property interest in the excess value in a home sold to satisfy delinquent property taxes. In 1935, he said that "the State purported to extinguish that property interest by enacting a law providing that an owner forfeits her interest in her home when she falls behind on her property taxes."

Against the backdrop of state law, the Chief Justice explored precedent regarding the Takings Clause. Contained in the Fifth Amendment, the clause provides that "private property [shall not] be taken for public use, without just compensation."

The Chief Justice noted that the clause itself "does not define property." He stated the question as "whether that remaining value is property under the Takings Clause, protected from uncompensated appropriation by the State."

The Chief Justice said that state law "is one important source" for defining property rights "but cannot be the only source." Otherwise, he said, the state could "sidestep" the Takings Clause by disavowing traditional property interests. He therefore looked at traditional property law principles "plus historical practice and this Court's precedents."

History

For the "principle that a government may not take more from a taxpayer than she owes," the Chief Justice went back to "Runnymeade in 1215" and found that the principle "became rooted in English law" by acts of Parliament and common law. Then, he said, the principle "made its way across the Atlantic."

Today, the Chief Justice said that the county identified only three states that deem property "entirely forfeited" for delinquent taxes. In contrast, he said that 36 states and the federal government "require that the excess value be returned to the taxpayer."

High Court Precedent

Citing decisions by the Court in 1881 and 1884, the Chief Justice said that "[o]ur precedents have also recognized the principle that a taxpayer is entitled to the surplus in excess of the debt owed." The county, in response, relied on *Nelson* v. *City of New York*, 352 U.S. 103 (1956), where the Court upheld the foreclosure of property for unpaid water bills.


The Chief Justice distinguished *Nelson* by noting how the taxpayer had waived a statutory right to recover the surplus. There was no Takings Clause violation, because the city had not absolutely precluded the owner from recovering the surplus.

The Chief Justice said that Minnesota "itself recognizes that in other contexts a property owner is entitled to the surplus in excess of her debt." For example, he mentioned real estate mortgage foreclosures, where a homeowner is entitled to the surplus after foreclosure.

The Chief Justice reversed the Eighth Circuit, saying that the homeowner "has plausibly alleged a taking under the Fifth Amendment," because the state made "an exception only for itself, and only for taxes on real property." Minnesota, he said, "may not extinguish a property interest that it recognizes everywhere else to avoid paying just compensation when it is the one doing the taking."

The Concurring Opinion

Agreeing there was a "plausibly alleged" violation of the Takings Clause, Justice Neil M. Gorsuch wrote a concurring opinion, joined by Justice Ketanji Brown Jackson. They wrote separately to deal with the Excessive Fines Clause in the Eighth Amendment.

In addition to the Takings Clause, the Eighth Circuit had found no violation of the Excessive Fines Clause. The Chief Justice did not address the Eighth Amendment, because the homeowner said that the finding of a Takings Clause violation would fully remedy her harm.

Justices Gorsuch and Jackson concurred because, they said, "even a cursory review" of the circuit's decision "reveals that it too contains mistakes future lower courts should not be quick to emulate."

The Eighth Circuit saw no Eighth Amendment violation, because they believed the statute to be remedial. Justice Gorsuch said, "It matters not whether the scheme has a remedial purpose, even a predominantly remedial purpose." The Excessive Fines Clause does not apply only when the statute is solely remedial.

According to Justice Gorsuch, the district also found no Eighth Amendment violation because the statute was not punitive, since it did not turn on culpability. He said that a statute may still be punitive if it uses punishment as a deterrent.

Justice Gorsuch ended his concurrence by saying:

> Economic penalties imposed to deter willful noncompliance with the law are fines by any other name. And the Constitution has something to say about them: They cannot be excessive.


Observations

The finding of a constitutional right to the surplus in a tax foreclosure may put a related issue to rest: Can a tax foreclosure be attacked in bankruptcy as a fraudulent transfer?

In *BFP v. Resolution Trust*, 511 U.S. 531 (1994), the Supreme Court held that regularly conducted real estate mortgage foreclosures cannot be fraudulent transfers, no matter how much equity the debtor loses above the mortgage debt.

The Fifth, Ninth and Tenth Circuits expanded *BFP* by holding that real estate tax foreclosures cannot be avoided as fraudulent transfers. The most recent of those decisions came from the Ninth Circuit. *See Tracht Gut, LLC v. Los Angeles County Treasurer*, 836 F.3d 1146 (9th Cir. 2016). To read ABI's report on *Tracht Gut*, click here.

The Second, Third, Sixth and Seventh Circuits have held that real estate tax foreclosures can be attacked as fraudulent transfers. To read ABI's reports, click here, here, here and here.

Since a tax foreclosure can violate the Constitution, it stands to reason that a tax foreclosure can be avoided as a fraudulent transfer.

Granted, the standards for finding a constitutional violation and a constructively fraudulent transfer are different. Given that courts will not rule on constitutional questions when the same result can be reached by other means, this writer believes that courts in the future will examine real estate tax forecloses to find fraudulent transfers before turning to the Constitution.

This writer bases his belief on the holding by the Chief Justice that a homeowner has a constitutionally protected property interest in the surplus arising from a tax foreclosure.

Indeed, one could ask whether *BFP* can be reconciled with *Tyler*. If the surplus in foreclosure is constitutionally protected property, how can a real estate tax foreclosure pass muster no matter how much equity the owner loses in foreclosure?

The opinion is *Tyler v. Hennepin County*, 22-166 (Sup. Ct. May 25, 2023).


***The Supreme Court resolved a split of circuits in an opinion that could give support to the notion that arbitration agreements are not enforceable in bankruptcy.***

# Supreme Court: The Bankruptcy Code Waived Tribes' Sovereign Immunity

Over a dissent by Justice Neil M. Gorsuch, Justice Ketanji Brown Jackson held for herself and six other justices that Section 106(a) of the Bankruptcy Code waives sovereign immunity as to tribes of Native Americans.

Justice Clarence Thomas concurred in the judgment, believing that tribes never had sovereign immunity to begin with.

Compelling Facts for the Debtor

The debtor borrowed $1,100 from a corporate payday lender before filing bankruptcy. The lender was owned by a federally recognized tribe. By the time the debtor filed a chapter 13 petition, the debt had grown to almost $1,600 as an unsecured, nonpriority claim.

Despite the automatic stay and despite being told about the bankruptcy, the tribal lender continually called the debtor demanding payment. Two months after bankruptcy, the debtor attempted suicide, blaming his action on the incessant calls.

In bankruptcy court, the debtor sought an injunction to halt collections attempts, along with damages and attorneys' fees. The bankruptcy court granted the tribe's motion to dismiss, based on sovereign immunity. The First Circuit accepted a direct appeal and reversed over a vigorous dissent.

For the majority, First Circuit Judge Sandra L. Lynch took sides with the Ninth Circuit, which had held in 2004 that Section 106(a) abrogated sovereign immunity for tribes. *Krystal Energy Co. v. Navajo Nation*, 357 F.3d 1055, 1061 (9th Cir. 2004). She disagreed with the Sixth Circuit, which found no waiver in 2019. *In re Greektown Holdings, LLC*, 917 F.3d 451, 460- 61 (6th Cir. 2019), *cert. dismissed sub nom. Buchwald Cap. Advisors LLC v. Sault Ste. Marie Tribe*, 140 S. Ct. 2638 (2020). While the *certiorari* petition was pending in *Greektown*, the case settled, and the petition was dismissed. To read ABI's report on *Greektown*, click here.


The debtor in the First Circuit filed a petition for *certiorari*, which the Court granted in September. Oral argument was held in January. To read ABI's report on argument, click here.

The Majority's Rationale

Justice Jackson began her June 15 opinion by laying out the law on waivers of sovereign immunity. Congressional intent to waive immunity must be made in "unequivocal terms." Although the Court does not oblige Congress to use "magic words," the intent to waive must be "unmistakably clear" or "clearly discernable" from the statute.

The circuits were split because the statute arguably leaves something to be desired. For "governmental units," Section 106(a) waives sovereign immunity as to a long list of sections in the Bankruptcy Code. The Section 362 automatic stay is on the list.

Section 101(27) defines "governmental unit." Regarding waiver as to tribes, the question for the Supreme Court was whether tribes come under the rubric of "other foreign or domestic government," as used in Section 101(27).

Justice Jackson did not leave the reader in doubt. After laying out general law, she said:

> [T]he Bankruptcy Code unequivocally abrogates the sovereign immunity of any and every government that possesses the power to assert such immunity. Federally recognized tribes undeniably fit that description; therefore, the Code's abrogation provision plainly applies to them as well.

To justify the conclusion, Justice Jackson wrote a 16-page opinion, one page shorter than the dissent. She said that the statutory "definition of 'governmental unit' exudes comprehensiveness from beginning to end." By "coupling foreign and domestic together, and placing the pair at the end of an extensive list, Congress unmistakably intended to cover all governments in §101(27)'s definition, whatever their location, nature, or type," she said.

Justice Jackson found reinforcement in other aspects of the Bankruptcy Code, such as the application of the Code's "requirements generally . . . to all creditors. "

Finding no "indication" that Congress "categorically" excluded "certain governments" from the Code's "enforcement mechanisms and exceptions," Judge Jackson identified the "one remaining question" as whether federally recognized tribes "qualify as governments."

Justice Jackson said that Congress "repeatedly characterizes tribes as governments." Given that the "Code unequivocally abrogates the sovereign immunity of all governments, categorically," and that "Tribes are indisputably governments," she held that "§106(a) unmistakably abrogates their sovereign immunity too."


The Tribe's Arguments Rejected

Justice Jackson devoted the final six pages of her opinion to rebutting the tribe's arguments, such as the fact that every other case finding a waiver involved a statute that specifically mentioned tribes.

Justice Jackson said that "the universe of cases . . . is exceedingly slim," and the fact that Congress had mentioned tribes specifically "does not foreclose it from using different language to accomplish that same goal in other statutory contexts."

Justice Jackson addressed the dissent by Justice Gorsuch, who described tribes as a "hybrid" that is neither "foreign" nor "domestic." She found it "hard to see why the Code would subject purely foreign or domestic governments to enforcement proceedings while at the same time immunizing government creditors that have both foreign and domestic attributes."

Finally, Justice Jackson said that the definition of "governmental unit" is "undeniably broader" in the Bankruptcy Code than it was under the former Bankruptcy Act. "[H]owever Congress may have treated governmental entities in bankruptcy law prior to 1978," she said, "it had clearly altered its view about the scope of coverage relative to governments by the time it enacted §101(27) and §106(a)."

Justice Jackson affirmed the First Circuit.

The Concurrence

Justice Thomas concurred in the judgment, but on entirely different grounds. He said that "the Court should simply abandon its judicially created tribal sovereign immunity doctrine."

Citing his own dissent in a prior case, Justice Thomas said that tribal sovereign immunity was not mandated by the Constitution but was a common law doctrine. "Because no federal law accords tribes sovereign immunity in federal court," he said, the tribe "lack[s] immunity in this federal case."

Furthermore, Justice Thomas said that governments protected by sovereign immunity have no protection for their "commercial acts."

"Accordingly," Justice Thomas said, "any common-law immunity that [the tribe] possess[es] cannot support [its] claim to immunity in federal court for their off-reservation commercial conduct."

The Dissent by Justice Gorsuch


Justice Gorsuch opened his 17-page dissent by saying that tribes were specifically mentioned in the statute every time the Court has previously found a waiver of sovereign immunity. Although the majority's interpretation was "plausible," he said that "plausible is not the standard our tribal immunity jurisprudence demands."

From "two centuries of history and precedent," Justice Gorsuch said, "Tribes [have enjoyed] a unique status in our law," meaning that they are neither "foreign" nor "domestic." Because the Bankruptcy Code does not refer to tribes specifically, he found no waiver.

Justice Gorsuch addressed the majority's notion that the Bankruptcy Code "exudes comprehensiveness." He said it's "true but not obviously helpful," because the Court has never "held that a statute's general atmospherics can satisfy the clear-statement rule when the text itself comes up short."

Quoting his own concurrence in a case last term, Justice Gorsuch "respectfully" dissented because Congress cannot use "oblique or elliptical language."

Observations

Policy arguments typically gain little or no traction in textualist decisions by the Supreme Court.

It is therefore noteworthy that Justice Jackson found support for her conclusion in "[o]ther aspects of the Bankruptcy Code" and "the Code's 'orderly and centralized' debt-resolution process," which, she said, "generally apply to *all* creditors." [Emphasis in original.]

At least when it comes to decisions involving the Bankruptcy Code, the Supreme Court might be amenable to interpreting a confusing provision in light of the larger principles undergirding the Code.

If a case one day asks the Supreme Court to decide whether arbitration agreements are enforceable in bankruptcy, the statement by Justice Jackson that the Code's provisions "generally apply to *all* creditors" suggests that arbitration agreements are unenforceable in bankruptcy, given the Code's "orderly and centralized" processes.

The opinion is *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin,* 22-227 (Sup. Ct. June 15, 2023).


***The Supreme Court ducked the question of whether Puerto Rico and other U.S. territories are entitled to Eleventh Amendment sovereign immunity just like states.***

# Supreme Court Holds that PROMESA Didn't Waive Puerto Rico's Sovereign Immunity

Over a dissent by Justice Clarence Thomas, the Supreme Court *assumed* that Puerto Rico and the Financial Oversight and Management Board are entitled to sovereign immunity like a state. In her opinion of the Court on May 11, Justice Elena Kagan reversed the First Circuit by holding that nothing in the Puerto Rico Oversight, Management, and Economic Stability Act, or PROMESA (48 U.S.C. §§ 2161 *et. seq.*), waived the Oversight Board's sovereign immunity.

The Origins of PROMESA and the Board

After the Supreme Court ruled that Puerto Rico was ineligible for municipal bankruptcy in chapter 9 of the Bankruptcy Code, Congress quickly enacted PROMESA, which adopts large portions of chapter 9. Puerto Rico and many of its instrumentalities sought relief under PROMESA in 2017 in what is known as Title III debt-adjustment proceedings.

In the Title III proceedings, Puerto Rico's federally appointed Financial Oversight and Management Board in substance represented Puerto Rico and its instrumentalities. In April 2022, the First Circuit upheld confirmation of the Oversight Board's plan of adjustment for the Commonwealth of Puerto Rico. To read ABI's report, click here.

In 2017 and again in 2019, nonprofit media organizations filed suit in federal district court in Puerto Rico, asking the PROMESA court to compel the Oversight Board to disclose broad categories of information and communications regarding the proceedings. The Board filed a motion to dismiss based on Eleventh Amendment sovereign immunity, among other things.

The district court denied the motion to dismiss and ordered the production of documents and other information. The district court reasoned that the Board was entitled to sovereign immunity but that Section 106 of PROMESA had waived and abrogated immunity.

The Board appealed.

First Circuit Finds a Waiver of Immunity


The First Circuit had previously held that Puerto Rico and the Oversight Board were entitled to sovereign immunity. Therefore, the First Circuit only considered on appeal whether PROMESA had waived sovereign immunity as to the suit by the news organization.

Finding a waiver of sovereign immunity, the majority on the First Circuit panel principally relied on Section 106 of PROMESA, which says that "any action against the . . . Board, [or] . . . otherwise arising out of [PROMESA] . . . shall be brought in [the district court for the district of Puerto Rico]." 48 U.S.C. § 2126(a).

By the inclusion of Section 106, the First Circuit majority reasoned that "Congress unequivocally stated its intention that the Board could be sued for 'any action . . . arising out of [PROMESA],' but only in federal court. Congress was unmistakably clear that it had contemplated remedies for constitutional violations and that injunctive or declaratory relief against the Board may be granted." *Financial Oversight & Management Board for Puerto Rico v. Centro de Periodismo Investigativo Inc.*, 35 F.4th 1, 17 (1st Cir. May 17, 2022). To read ABI's story, click here.

The majority on the appeals court panel affirmed the district court's order denying the motion to dismiss, finding a waiver of sovereign immunity.

In dissent, Circuit Judge O. Rogeriee Thompson found "[a]bsolutely nothing in the text of [Section 106 that] sets forth an intent to abrogate Eleventh Amendment immunity." *Id*. at 21. Announcing a theme that later persuaded Justice Kagan, Judge Thompson said that the "Supreme Court has repeatedly held that jurisdiction-granting clauses like § 106 do not abrogate Eleventh Amendment immunity. [Footnote omitted.]" *Id*. at 22.

Believing there was no abrogation of sovereign immunity, Judge Thompson "respectfully" dissented, ending her opinion by saying that "today's decision should not go uncorrected." *Id*. at 25.

The Oversight Board filed a petition for *certiorari* in July 2022. The petition stated the question presented as whether Section 106 of PROMESA abrogated the Oversight Board's sovereign immunity. The Court granted the petition in October. Argument was held in January.

The Opinion of the Court

Justice Kagan restated the question presented as "whether [PROMESA] categorically abrogates (legalspeak for eliminates) any sovereign immunity the board enjoys from legal claims."

Telling the reader in the first paragraph that she was reversing, Justice Kagan said:


> Under long-settled law, Congress must use unmistakable language to abrogate sovereign immunity. Nothing in the statute creating the Board meets that high bar.

Justice Kagan found nothing "explicit" in PROMESA about the abrogation of sovereign immunity except for Title III cases. "In particular," she said, "no provision states that it is abrogating any immunity the Board possesses from legal claims."

"At the same time," Justice Kagan said, "several provisions of PROMESA contemplate that, even outside the Title III context, the Board may confront legal claims against it."

Justice Kagan found only two circumstances where Congress has issued an "unequivocal declaration" abrogating immunity. The first is when the statute "says in so many words that it is stripping immunity." The second "is when a statute creates a cause of action and authorizes suit against a government on that claim."

"PROMESA fits neither of those molds," Justice Kagan said.

Reversing the First Circuit and remanding, Justice Kagan held:

> In short, nothing in PROMESA makes Congress's intent to abrogate the Board's sovereign immunity "unmistakably clear." *Kimel*, 528 U.S., at 73. The statute does not explicitly strip the Board of immunity. It does not expressly authorize the bringing of claims against the Board. And its judicial review provisions and liability protections are compatible with the Board's generally retaining sovereign immunity.

The Dissent by Justice Thomas

Justice Kagan said that the First Circuit and the district court "simply assumed the Board's immunity before turning to the abrogation issue."

"We took the case on those terms, and we resolve it on those terms," Justice Kagan said. "That means we assume without deciding that Puerto Rico is immune from suit in federal district court, and that the Board partakes of that immunity."

Justice Thomas would have affirmed the First Circuit, but on the very ground that the majority assumed without deciding.

Justice Thomas explained how the Oversight Board claimed sovereign immunity under the Eleventh Amendment. He paraphrased the amendment to mean that "the Constitution does not allow federal or state courts to hear cases against States without their consent."


Working from the proposition that Puerto Rico is a territory and not a state, Justice Thomas said it "is difficult to see how the same inherent sovereign immunity that the States enjoy in federal court would apply to Puerto Rico." He said that the Oversight Board's argument for Eleventh Amendment immunity was "untenable."

Justice Thomas would have affirmed because he believes that the Oversight Board had not established its immunity.

Observations

For Puerto Rico, the case is notable in that the majority ducked the question of whether territories are entitled to sovereign immunity. If the question is ever presented to the Court, the dissent means that Justice Thomas would see no constitutional immunity for territories because they are not states. How he would feel about tribes of Native Americans is less clear.

Indeed, tribal sovereign immunity is *sub judice* in the Supreme Court in *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin,* 22-227 (Sup. Ct.). The case was argued on April 24. Similar to the PROMESA case, the First Circuit had deepened an existing circuit split by holding over a lengthy dissent in *Lac du Flambeau* that Sections 106(a) and 101(27) of the Bankruptcy Code waived sovereign immunity as to Native American tribes. To read ABI's report on oral argument, click here.

The PROMESA decision doesn't indicate how the Court will decide *Lac du Flambeau*, except to say that "abrogation requires an 'unequivocal declaration' from Congress." Presumably, the decision in *Lac du Flambeau* will tell us whether "other foreign or domestic government" in Section 101(27) is an unequivocal reference to tribes that waives immunity.

It's a good bet, however, that Justice Kagan will write the opinion in *Lac du Flambeau*.

The opinion is *Financial Oversight & Management Board for Puerto Rico v. Centro de Periodismo Investigativo Inc.*, 22-96 (Sup. Ct. May 11, 2023).


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

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

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

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

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

The Fee Structure's History

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

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

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

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


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

Procedural History

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

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

The debtor mounted an objection to the increase on constitutional grounds and won. Bankruptcy Judge Kevin R. Huennekens of Richmond, Va., held that the increased fees violated the Uniformity Clause, if the fee is seen as a tax, and violated the Bankruptcy Clause, if the fee is considered a user fee. *In re Circuit City Stores Inc.*, 606 B.R. 260 (Bankr. E.D. Va. July 15, 2019). To read ABI's report, click here.

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

The Fourth Circuit agreed to hear an interlocutory appeal and reversed in a 2/1 decision. The majority on the Richmond, Va.-based appeals court did not believe that the increase was arbitrary. The dissenter would have held the increase to be unconstitutional. *In re Circuit City Stores, Inc.*, 996 F.3d 156 (4th Cir. April 29, 2021). To read ABI's report, click here.

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

Applicability of the Bankruptcy Clause

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

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


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

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

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

Precedent Foretells the Outcome

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

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

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

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

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


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

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

Impermissible Lack of Uniformity

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

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

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

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

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

Final Comments by Justice Sotomayor

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

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


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

Is the Dual System Constitutionally Sound?

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

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

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

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

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

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

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

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


The debtor-plaintiff appealed and is asking the Federal Circuit to reinstate the class action. Oral argument in the Federal Circuit was postponed pending the outcome in *Circuit City*. For ABI's report on *Acadiana*, click here.

The opinion is *Siegel v. Fitzgerald*, 21-441 (Sup. Ct. June 6, 2022).


# Reorganization


# *Solvent Companies and Bad Faith*


***Bound by the Third Circuit's first LTL decision, the bankruptcy court found that LTL's rejiggered second filing suffered from the same defect: no immediate financial distress.***

# J&J's 'Baby Powder' Chapter 11 Case Dismissed a Second Time: No Financial Distress

Twice within six months, Johnson & Johnson has suffered dismissal of chapter 11 petitions filed by a subsidiary that aimed to resolve asbestos liability for the entire corporate family, debtors and nondebtors alike.

The new dismissal will result from the July 28 opinion by Chief Bankruptcy Judge Michael B. Kaplan of Trenton, N.J. At the end of January, the Third Circuit reversed Judge Kaplan and ordered him to dismiss the first "Baby Powder" case because it was not filed in good faith given the lack of "financial distress." *See In re LTL Management LLC*, 58 F.4th 738, 64 F.4th 84 (3d Cir. Jan. 30, 2023). To read ABI's report on *LTL II*, click here.

Two hours after Judge Kaplan signed the dismissal order required by the Third Circuit in *LTL II*, J&J put the same subsidiary back into chapter 11. The new filing was accompanied by support agreements signed by lawyers saying they represented almost 60,000 asbestos claimants. In addition, the new filing had a different funding agreement with nondebtor J&J companies.

Bound by *LTL II* in his new opinion on July 28, Judge Kaplan directed dismissal of the new filing because there was no "imminent and immediate financial distress."

The New Filing

LTL Management LLC was first created as a limited liability company in Texas and converted to a North Carolina limited liability company. Two days after its creation, the debtor filed a chapter 11 petition in Charlotte, N.C., that was transferred to New Jersey.

The creation of LTL was part of a so-called Texas divisional merger. The debtor LTL took no business operations of its own but assumed liability for all talc-related claims.

After being spurned by the Third Circuit, LTL filed a chapter 11 petition again on April 4. Dismissal of the first LTL case didn't occur immediately after the Third Circuit's January 30 opinion because the debtor filed unsuccessful petitions in the circuit for rehearing and rehearing *en banc* and for a stay of the circuit's issuance of the mandate.


The new filing was accompanied by plan support agreements endorsed by lawyers allegedly representing almost 60,000 claimants who said they were injured by using J&J's Baby Power, which allegedly contained asbestos. If confirmed, the plan described in the support agreements would have created an $8.9 billion trust at net present value. The funding agreement in the first chapter 11 case provided the debtor LTL with perhaps $61.5 billion to cover liabilities arising from the talc contained in Baby Powder that allegedly contained asbestos.

The J&J companies terminated the funding agreement that underpinned the first LTL filing. The new funding agreement obligates nondebtor J&J companies to pay for asbestos liabilities and other costs incurred in the normal course of business. The new agreement also has backstop funding for a chapter 11 plan, but only if the confirmed plan is consistent with the plan support agreements.

Soon after the new filing, Judge Kaplan entered a temporary restraining order imposing a stay on talc lawsuits. The new TRO protected both LTL and potentially hundreds of other nondebtor third parties, including the J&J parent and affiliates. As required on issuance of a TRO, Judge Kaplan scheduled a preliminary injunction hearing to be held on April 18. Two days later, he issued his opinion from the bench, vacating the original TRO while imposing a more limited preliminary injunction. He followed the bench opinion with a written opinion. *LTL Management v. Those Parties Listed on Appendix A (In re LTL Management LLC)*, 23-01092, 2023 BL 143084 (Bankr. D.N.J. April 27, 2023). To read ABI's report, click here.

In issuing the injunction, Judge Kaplan said he would revisit the injunction once again at a hearing that began in late June. At the same four-day evidentiary hearing, he also considered 10 motions to dismiss and two joinders filed by parties in interest who argued that the new filing, like its precedessor, was in "bad faith."

Reasons for the Second Dismissal

The motions to dismiss contended there was "cause" for dismissal under Section 1112(b) because the new petitions were not filed in good faith. To qualify for chapter 11 relief, Judge Kaplan characterized the Third Circuit as having held in *LTL II* "that the Debtor's financial distress must be 'immediate, 'imminent' and 'apparent.'"

Given the new funding agreement, Judge Kaplan fund "no immediate financial distress," because even the forced liquidation value of the affiliates providing the funding "could cover the Debtor's total estimated worst-case scenario for talc liability."

Although he found "cause" for dismissal, Judge Kaplan identified Section 1112(b)(1) and (2) as requiring him to decide whether continuing the chapter 11 case would be "in the best interest of creditors."


Judge Kaplan assumed, without finding, that "unusual circumstances" existed under Section 1112(b)(2) to obviate dismissal, and "the possibility that best interests of the creditors warrants continuation of this chapter 11 case" under Section 1112(b)(1).

Judge Kaplan held that the debtor's lack of financial distress is not the type of bad faith "that could be subject" to the Section 1112(b)(2) exception to prevent dismissal. He said it was "clear" under Third Circuit precedent that "an alternative to dismissal is reserved for only those who properly belong in bankruptcy," and the debtor LTL wasn't properly in bankruptcy for lack of financial distress.

Before ending his decision, Judge Kaplan rejected the idea of appointing a trustee or examiner as an alternative to dismissal under Section 1112(b)(1).

While directing the parties to settle an order dismissing the case for "lack of imminent and immediate financial distress," Judge Kaplan "strongly encouraged" everyone "to continue to pursue a global resolution."

Unique Aspects of the Opinion

Not bearing directly on the debtor's lack of financial distress, Judge Kaplan salted his opinion with language that could be used by courts more receptive to mass tort bankruptcies.

Judge Kaplan said that his "beliefs as to the benefits and advantages of bankruptcy, or the appropriateness of employing a chapter 11 filing to resolve mass tort liability, are of no moment for resolution of the pending Motions" to dismiss. He nonetheless questioned whether requiring immediate financial distress was in the best interests of the estate or creditors.

Waiting to pursue chapter 11 relief until distress is imminent "often gives rise to serious risks and increased costs that may threaten the viability of the business," Judge Kaplan said. He added, "Drawing upon the history of mass tort bankruptcies, most companies fare no better when trying to ride out massive, decades-long litigation firestorms."

Judge Kaplan offered his thoughts on the superiority of bankruptcy over the tort system when satisfying the claims of creditors. He alluded to "the incontrovertible fact that many plaintiffs are denied any recovery in the tort system altogether." He was also troubled by the "sluggish speed of the tort system" and "the need to protect the interests of future claimants."

With regard to a global settlement outside of bankruptcy, Judge Kaplan said:


> No party or expert has identified even a single example of a global settlement outside of bankruptcy that has been achieved in circumstances like this case — where both latent injuries and unknown future claimants exist.

Similarly, Judge Kaplan was "unconvinced that procedural mechanisms and notice programs" would protect future claimants in the tort system.

Judge Kaplan was constrained to dismiss because he read the Code as precluding him from considering the best interests of creditors given a bad faith filing for lack of financial distress.

The opinion is *LTL Management LLC*, 23-12825 (Bankr. D.N.J. July 28, 2023).


***The Fourth Circuit majority upheld a preliminary injunction barring tort suits against a debtor's nonbankrupt affiliates following a Texas divisional merger.***

# A Fourth Circuit Dissenter Opposes Mass-Tort Injunctions Protecting Non-Debtors

A dissenter in the Fourth Circuit is the latest example of an Article III judge antagonistic to idea of allowing large, solvent companies to fend off their own mass tort liability by putting an affiliate into chapter 11.

Espousing a new strategy for precluding the use of the bankruptcy court in obtaining the release of tort liability for non-debtors, Circuit Judge Robert Bruce King would have ruled that the use of a so-called Texas divisional merger manufactured federal jurisdiction in violation of 28 U.S.C. § 1359.

On the last page of the opinion in which he "respectfully" dissented, Judge King quoted an *amicus* brief filed in the Seventh Circuit on behalf of six U.S. senators and two representatives, urging the appeals court to uphold denial of non-debtor injunctions in the chapter 11 reorganization of a subsidiary of 3M Corp. The *amici* said:

> [I]n recent years, the Bankruptcy Code has increasingly been manipulated by solvent, blue-chip companies faced with mass tort liability and is becoming a font for abuse by mammoth corporations with billions on their balance sheets. Through dubious readings of the Bankruptcy Code that Congress never intended, financially healthy corporations and those that control them have invented elaborate loopholes enabling them to pick and choose among the debt-discharging benefits of bankruptcy without having to subject themselves to its creditor-protecting burdens — and without ever declaring bankruptcy themselves.

*In re Aearo Techs., LLC*, No. 22-2606, at 3-4 (7th Cir. Feb. 1, 2023), ECF No. 89.

Upholding the lower courts' conclusions that the bankruptcy court had "related to" jurisdiction, the Fourth Circuit majority found no abuse of discretion in issuing a preliminary injunction barring suits against non-debtor affiliates.

The Georgia-Pacific Divisional Merger


The facts were similar to those where Johnson & Johnson employed a Texas divisional merger to segregate mass tort liability into a subsidiary that would file a chapter 11 petition to obtain an injunction barring suits against the entire non-debtor corporate family.

In 1965, Georgia-Pacific merged with Bestwall Gypsum, which made products containing asbestos. Thousands of lawsuits ensued.

In 2017, GP underwent a Texas divisional merger. The "old" GP ceased to exist. Two companies were created in its place. Bestwall became solely responsible for mass tort liability, while a newly created company, that we shall refer to as New GP, received all of the assets of "old" GP but was not responsible for any asbestos liability.

Both Bestwall and New GP became wholly-owned subsidiaries of a holding company. Just like the J&J, Bestwall could draw on a funding agreement requiring New GP to pay any asbestos liabilities, in bankruptcy or outside of bankruptcy.

Following the divisional merger, Bestwall filed a chapter 11 petition in Charlotte, N.C. Immediately, the debtor filed an adversary proceeding and sought a preliminary injunction to halt lawsuits against New GP.

Finding "related to" jurisdiction under Section 1334, the bankruptcy granted the preliminary injunction. On appeal by the official creditors' committee and the future claimants' representative, the district court affirmed. The committee and the representative appealed to the Circuit.

The Majority Opinion

The appellants argued on appeal that the bankruptcy court lacked jurisdiction to impose the preliminary injunction.

For the majority, Circuit Judge G. Steven Agee said that the Fourth Circuit uses a "broad test" for "related to" jurisdiction under Section1334(a). He said that the asbestos claims against New GP are "identical" to those against Bestwall and that the claims against New GP could have an "effect" on Bestwall.

Judge Agee quickly found "related to" jurisdiction and devoted the remainder of his opinion countering the dissenter's contention that New GP "manufactured" federal jurisdiction in violation of 28 U.S.C. § 1359. The section provides that a "district court shall not have jurisdiction of a civil action in which any party, by assignment or otherwise, has been improperly or collusively made or joined to invoke the jurisdiction of such court."

Judge Agee said that the companies "did not manufacture jurisdiction via their Texas divisional merger." Absent the merger, he said that the claims would have been asserted against Old GP. If


Old GP had filed bankruptcy, there would have been jurisdiction. He therefore reasoned that the bankruptcy court had the same jurisdiction as though the merger had never taken place.

Judge Agee rejected the creditors' reliance on the Third Circuit's dismissal of the chapter 11 case filed by LTL Management, a subsidiary of Johnson & Johnson. *See In re LTL Management LLC*, 58 F.4th 738, 64 F.4th 84 (3d Cir. Jan. 30, 2023). The Third Circuit, he said, dismissed for a lack of good faith given the absence of "financial distress." To read ABI's report on *LTL*, click here.

The Third and Fourth Circuits have different "good faith" standards. Judge Agee recounted how the Third Circuit "recognized" that the Fourth Circuit employs a "more comprehensive standard" requiring both subjective bad faith and an objective futility of any possible reorganization.

The creditors, Judge Agee said, "made no showing to this Court of either required element." He held that the district court "correctly rejected" the idea that the companies "manufactured jurisdiction."

Judge Agee ended his majority opinion by finding that the bankruptcy court had employed the proper standard for a preliminary injunction.

According to Judge Agee, the debtor had shown the likelihood of success on the merits by demonstrating a "realistic likelihood of successfully reorganizing" and was not required to make a clear showing of the ability to reorganize.

For the majority, Judge Agee upheld the preliminary injunction.

The Dissent

In the first paragraph of his dissent, Judge King quoted the Supreme Court for saying that bankruptcy is for "insolvent" or "bankrupt" companies. In "recent years," he said,

> major and fully solvent business corporations have managed to skirt that debtor-centric objective and obtain shelter from sweeping tort litigation without having to file for bankruptcy themselves. It is precisely that sort of manipulation of the Bankruptcy Code . . . that lies at the heart of this important appeal.

Before explaining the legal grounds on which he would have denied the injunction, Judge King said that the companies "manufactured the jurisdiction of the bankruptcy court in these proceedings, in an unmistakable effort to gain leverage over future asbestos claims against New GP."


Judge King said that the divisional merger "was designed [for New GP] to receive bankruptcy protection despite its non-debtor status, with no need to submit to the bankruptcy court's oversight or to suffer the burdens appurtenant to a Chapter 11 filing."

Conceding that the claims against New GP were "related to" the bankruptcy, Judge King pointed to Section 1359 and said that "the entire factual basis for invoking the bankruptcy court's 'related-to' jurisdiction was contrived."

Explaining the applicability of Section 1359, Judge King said that Old GP "reformed its corporate existence precisely so that its principal successor entity, New GP, could be afforded bankruptcy relief without ever having to file for bankruptcy." He therefore would have held that the bankruptcy court was without jurisdiction to enter the injunction, because "jurisdiction consistently flows from an orchestrated endeavor to fabricate it."

Judge King would have reversed with directions to vacate the injunction, saying that the injunction runs "directly counter to the purposes of the Bankruptcy Code."

The opinion is *Official Committee of Asbestos Claimants v. Bestwall LLC (In re Bestwall LLC)*, 22-1127 (4th Cir. June 20, 2023).


***Indianapolis Bankruptcy Judge Jeffrey Graham says that the bankruptcy court cannot become "another court of general jurisdiction."***

# J&J, Redux: Bankruptcy Court Dismissed 3M Subsidiary's Chapter 11 Case

Just like the lack of "financial distress" prompted the Third Circuit to dismiss the first chapter 11 filing by Johnson & Johnson subsidiary LTL Management LLC, Bankruptcy Judge Jeffrey J. Graham of Indianapolis dismissed the chapter 11 case of a subsidiary of 3M Corp. for lack of "financial distress" and no demonstration of a "valid reorganization purpose."

In his June 9 opinion, Judge Graham said that the filing by 3M subsidiary Aearo Technologies LLC was "fatally premature" and that the debtor was employing chapter 11 to "solve problems that Congress did not design or intend the [Bankruptcy] Code to fix."

Judge Graham found the Third Circuit's logic to be "persuasive" in *LTL Management LLC*, 64 F.4th 84 (3d Cir. Jan. 30, 2023). In *LTL*, the Philadelphia-based appeals court held that "resort[ing] to Chapter 11 is appropriate only for entities facing financial distress." *Id*. at 111. To read ABI's report on *LTL*, click here.

The June 9 opinion was not 3M's first disappointment. In August 2022, Judge Graham found no jurisdiction to impose an injunction stopping lawsuits against nondebtors, like the parent 3M. *In re Aearo Tech. LLC*, 642 B.R. 891 (Bankr. S.D. Ind. Aug. 26, 2022). To read ABI's report, click here.

Aearo took a direct appeal to the Seventh Circuit from the order refusing to enjoin lawsuits against nondebtors. The appeal was argued in early April. Unless Aearo successfully appeals the June 9 dismissal order, the appeal from injunction denial may be moot.

The Faulty Earplugs

Aearo began making earplugs for the military in 2000. 3M acquired Aearo in 2008. Two years later, Aearo's businesses were "upstreamed" to 3M in return for $965 million payable to Aearo. Judge Graham said that 80% of earplug sales occurred before the upstreaming. He said it was "unclear" whether 3M assumed any liabilities as part of the upstreaming.

After 3M paid $9.1 million to settle a *qui tam* action, a deluge of lawsuits were filed alleging that the earplugs were defective. Aearo filed a chapter 11 petition in July 2022 that stopped


lawsuits against Aearo but not against 3M and nondebtor affiliates. Central to the reorganization, the Aearo subsidiary had uncapped funding from the 3M parent to pay judgments or settlements, whether arising in bankruptcy or not.

Immediately after filing, Aearo attempted to spread the Section 362 automatic stay to cover 3M and other nondebtor affiliates, but Judge Graham denied the initiative last August.

Today, more than 250,000 earplug suits are consolidated in multidistrict litigation in Florida, where the debtor and 3M are co-defendants. Judge Graham said that the multidistrict litigation is the largest in history and represents 30% of all civil cases currently pending in federal courts.

So far, there have been 18 bellwether trials. 3M and the debtor won six, but the plaintiffs won 12, yielding verdicts ranging between $1.7 million and $77.5 million.

3M called the multidistrict litigation a failure and proffered chapter 11 as the best method for resolving all earplug liabilities.

Perhaps emboldened by the Third Circuit's dismissal of the case by the J&J subsidiary, the earplug plaintiffs filed a motion asking Judge Graham to dismiss the Aearo case under Section 1112(b) for "cause." A separate committee representing plaintiffs who used allegedly defective respirators wanted Judge Graham to appoint a chapter 11 trustee instead.

Judge Graham took the matter under advisement after a five-day hearing concluding on April 25, and issued his 49-page opinion six weeks later dismissing the case without prejudice.

## The Financial Condition of the Debtor and 3M

The financial condition of Aearo and 3M was central to Judge Graham's legal conclusions. The debtor's expert estimated that the total earplug liability was less than $1 billion and that 3M has the ability to pay. Currently, Judge Graham said that Aearo is solvent on a balance-sheet and cash-flow analysis.

3M has book equity today of $14.7 billion and cash and cash equivalents of more than $3.6 billion. In 2022, 3M paid over $3.2 billion in dividends and bought back $1.4 billion in stock, Judge Graham said.

## The Law on Dismissal

On finding "cause," Section 1112(b) directs the court to convert to chapter 7 or dismiss, unless appointment of a chapter 11 trustee or an examiner is in the best interests of creditors. In addition to the 16 statutorily defined grounds for finding cause, Judge Graham said that "most courts generally agree that a case should also be dismissed under § 1112 if it was not filed in good faith."


While there is "no universally accepted definition of good faith" in the Section 1112 context, Judge Graham said it is also "unclear" in Seventh Circuit caselaw "whether it is bad faith for a financially healthy debtor to seek Chapter 11 relief." Of course, being insolvent is not a prerequisite for chapter 11, he said.

To determine the relevance of the debtor's financial condition, Judge Graham extensively analyzed a 1990 decision by retired Chicago Bankruptcy Judge Eugene Wedoff in *In re N.R. Guaranteed Retirement Inc.*, 112 B.R. 263 (Bankr. N.D. Ill. 1990). Finding the filing to have been "unnecessary" was the "most basic" ground for dismissal, Judge Wedoff said. *Id*. at 262.

Unwilling to adopt an unweighted, multi-factor test for good faith, Judge Graham cited the Seventh Circuit's opinion in *In re Madison Hotel Associates*, 749 F. 2d 410, 425 (7th Cir. 1984), for saying that the "better" measure is "whether the Chapter 11 case serves a 'valid reorganization purpose.'" The "central" question, he said, is the "debtor's 'need' for relief under Chapter 11."

What's a 'Valid Purpose'?

Next, Judge Graham addressed the definition of "valid reorganization purpose." He said that the need for chapter 11 is "inextricably tied" to bankruptcy "purpose."

One purpose, Judge Graham said, is to preserve or create value that would be lost outside of bankruptcy. Citing the Third Circuit among other authorities, he reported how courts "have consistently dismissed chapter 11 petitions by financially healthy companies with no need to reorganize under the protection of Chapter 11."

"When the debtor is solvent," Judge Graham said, "we begin to stray from Congress' intended application of the Code and valid bankruptcy purposes dwindle." The "line of reasoning," he said, "has arguably been most clearly articulated by the Third Circuit . . . most recently" in *LTL*, where the Court of Appeals found no "financial distress."

Finding *LTL* "persuasive," Judge Graham said that "the Court cannot conclude that the Aearo Entities' cases serve a valid reorganization purpose." The company "has been, and currently is, financially healthy." He found "simply no compelling evidence that the Pending Actions have had or will have, at least in the near term, any substantial effect on Aearo's operations. Aearo, simply put, is thriving even while living under the 'overhang' of the largest MDL in history."

Naturally, Judge Graham said that the uncapped "Funding Agreement plays an obvious and significant factor in the Court's conclusion that Aearo is financially healthy."


Turning to the other aspect of reorganization purpose, Judge Graham said "there is no material value preserved, created, or lost outside of bankruptcy." He could not "conclude that Aearo's bankruptcy creates or preserves any value that would be lost if these cases were dismissed."

Judge Graham found "cause" to dismiss the case under Section 1112(b).

No Trustee

The respirator committee wanted a chapter 11 trustee rather than dismissal. Judge Graham said that a trustee was not in the best interests of the estate or creditors, because he did not believe that "a trustee will necessarily add to or aid the process of reaching a global settlement."

Furthermore, Judge Graham said that the "appointment of a trustee does not ameliorate or obviate the fundamental problem that these cases simply do not, at least presently, serve a valid reorganizational purpose."

Conclusion

Judge Graham ended his opinion by finding a correlation between his decision to dismiss the case and his prior decision refusing to expand the automatic stay based on the lack of jurisdiction.

Although Section 1112(b) is not jurisdictional, Judge Graham said that requiring a valid bankruptcy purpose "protects this Court's jurisdictional integrity."

"Otherwise," Judge Graham said, "a bankruptcy court risks becoming another court of general jurisdiction, which it most decidedly is not." He added that allowing "an otherwise financially healthy debtor . . . to remain in bankruptcy . . . exceeds the boundaries of the Court's limited jurisdiction."

Judge Graham said that the chapter 11 filing was "fatally premature." He dismissed the case without prejudice so as not "to forestall a repeat filing . . . should the circumstances warrant it."

[Disclosure: This writer's brother is counsel for the Aearo respirator committee.]

The opinion is *In re Aearo Technologies LLC*, 22-02890 (Bankr. S.D. Ind. June 9, 2023).


***Bankruptcy Judge Whitley says that a no-opt-out plan for a solvent debtor might violate creditors' due process and jury trial rights.***

# With Reservations, a Chapter 11 Debtor with No Financial Distress Avoids Dismissal

Constrained by Fourth Circuit precedent, Bankruptcy Judge J. Craig Whitley of Charlotte, N.C., denied a motion to dismiss a pair of "asbestos" chapter 11 cases where the family of companies could pay $250 million in current and future liability without breaking a sweat.

In his December 28 opinion, Judge Whitley held that (1) the lack of "financial distress" does not divest the court of subject matter jurisdiction, and (2) there is no violation of the Bankruptcy Clause of the Constitution when the debtor has no "financial distress."

Overall, Judge Whitley deferred to the Fourth Circuit for an ultimate decision on whether solvent companies can utilize bankruptcy to clean up mass tort liability. However, Judge Whitley has language in the opinion to suggest that he might find a due process violation and deny confirmation of a chapter 11 plan for a family of solvent companies if the plan does not allow opting out.

Although Judge Whitley does not discuss *Harrington v. Purdue Pharma L.P.*, No. 23-124 (Sup. Ct.), much of his opinion could become moot if the Supreme Court decides that the bankruptcy court does not countenance nonconsensual, nondebtor, third-party releases. *Purdue* was argued on December 4. To read ABI's report on the argument, click here.

To appreciate the wealth of scholarship in Judge Whitley's 63-page opinion, we recommend reading the decision in full text.

The Solvent Family of Companies

Judge Whitley said there was no dispute that a family of companies were aiming to use chapter 11 to isolate asbestos liabilities to effect a global resolution giving absolution even to members of the group that would not themselves be filing bankruptcy.

For the sake of simplicity, we will compress the facts. Assume there was a large, solvent company that had several lines of business with products that previously used asbestos. The first lawsuits arose in the 1980s. By 2020 when the chapter 11 case began, there were


90,000 suits estimated to cost about $550 million ultimately. After available insurance, the company estimated that the net cost would be $240 million.

The company was very large and profitable. The book value of the company's equity was almost $11 billion. Annual revenue was about $16 billion, throwing off excess cash flow of more than $1.8 billion a year.

The company wanted to deal with existing and future asbestos liability without thrusting the entire enterprise into chapter 11. So, the company used the so-called Texas Two-Step divisional merger to create a new company that would assume all asbestos liability but would have no business, no employees and essentially no assets. At the same time, a new sister company was created to take all the assets and continue the profitable businesses.

The new company destined for chapter 11 was given a funding agreement where the nondebtor sister company would fund a trust to pay the costs of the chapter 11 case, along with current and future asbestos claims, as long as the plan gave the nondebtor a release. The funding agreement was unsecured and nonassignable. It required the plan to give the protections to the nondebtor that could be afforded a debtor by Section 524(g).

Seven weeks after the divisional merger, the debtor filed a chapter 11 petition. Early on, Judge Whitley protected the nondebtor with a preliminary injunction.

The official committee of asbestos claimants and several individual asbestos claimants filed a motion to dismiss, alleging that the filings were made in bad faith. The movants contended that the existence of financial distress was jurisdictional. Even given jurisdiction, the movants saw a violation of the Bankruptcy Clause of the Constitution when the debtor has no financial distress.

With important caveats and reservations, Judge Whitley denied the motion to dismiss.

The Tests for Bad Faith

Although courts will dismiss bankruptcies for lack of good faith, Judge Whitley said they do so "under a variety of tests." On one hand, the Third Circuit recently held that a lack of financial distress shows a lack of good faith. *See In re LTL Management LLC*, 58 F.4th 738, 64 F.4th 84 (3d Cir. Jan. 30, 2023). To read ABI's report, click here.

In contrast, Judge Whitley said that the Fourth Circuit has "a more restrictive two-prong test that requires the movant to demonstrate both the objective futility of the case and the subjective bad faith of the petitioner." *See Carolin Corp v. Miller,* 886 F.2d 693, 700-701 (4th Cir. 1989).


Financial Distress Isn't Jurisdictional

Article I, Section 8 of the Constitution gives Congress the power to enact "uniform laws on the subject of Bankruptcies." The movants submitted that the debtor's lack of financial distress deprived the bankruptcy court of subject-matter jurisdiction.

With little ado, Judge Whitley found "no provisions in the Bankruptcy Code evidencing a congressional intent to impose a jurisdictional insolvency or 'financial distress' requirement to file bankruptcy." He said that the movants' constitutional challenges are "not challenges to the Court's subject matter jurisdiction."

In a footnote, Judge Whitley mentioned that the Third Circuit in *LTL* found jurisdiction before dismissing for lack of financial distress.

Solvent Debtors and Unconstitutional Bankruptcies

The movants believed that applying the Bankruptcy Code to solvent debtors violates the Bankruptcy Clause. To resolve the question, Judge Whitley assumed that the debtor had no financial distress, but he found "no cases holding that the Constitution imposes a financial-distress requirement."

Judge Whitley nonetheless found "considerable force" in the arguments posited by Prof. Ralph Brubaker in *The Texas Two-Step and Mandatory Non-Opt-Out Settlement Powers*, HAR. L. REV. BANKR. ROUNDTABLE (July 12, 2022). For instance, he said:

> Common sense dictates that a solvent, nondistressed corporation should rarely consider bankruptcy — and even less often be afforded its protections. After all, in a capitalistic society, those who can pay their creditors, must pay.

Judge Whitley said that bankruptcies are "often" dismissed for bad faith, but "no court has adopted its conclusion that the Bankruptcy Clause requires insolvency." He concluded that "'financial distress' is not a constitutional prerequisite to filing chapter 11."

Constitutional Constraints on Debtors

Citing Prof. Brubaker's Texas Two-Step article and a piece by Prof. Melissa B. Jacoby, *Unbundling Business Bankruptcy Law*, 101 N.C. L. REV. 1703 (2023), Judge Whitley said that "opportunistic debtors" with no financial distress might violate creditors' rights under the Commerce Clause, the Due Process Clause or the Seventh Amendment. As an example, he cited the Supreme Court for holding that a class action settlement is unconstitutional when the defendant


is solvent and the settlement does not permit opting out. *Ortiz v. Fibreboard Corp.*, 527 U.S. 815, 817-818 (1999).

Citing Prof. Brubaker, Judge Whitley said that no-opt-out provisions can be permissible in a "limited fund" case where the assets to pay creditors are limited. Otherwise, he summed up the constitutional principles as follows:

> In sum, a "no-opt-out" bankruptcy plan and trust is entirely appropriate for an insolvent or even a distressed debtor. However, under *Ortiz* and for solvent and non-distressed debtors, a plan/trust which does not permit creditors to "opt out" and return to the tort system for their jury trials may cause an unconstitutional impairment of the claimants' due process and jury trial rights.

Judge Whitley noted that the debtor's plan was "no-opt-out" and that the trust was "capped." If the debtor and its nondebtor sister company are neither insolvent nor financially distressed, he asked, "is the plan constitutional?"

"[F]ortunately," Judge Whitley said, the question is "for another day," because he identified grounds for denying the motion to dismiss.

No Dismissal under *Carolin*

However he might have felt about the debtor's chapter 11 case, Judge Whitley said that he was bound by *Carolin*, "the longstanding standard in this Circuit for dismissal of a Chapter 11 bankruptcy case for bad faith." In *Carolin*, he described the Fourth Circuit as holding that "a Chapter 11 case may be dismissed as a bad faith filing only when the bankruptcy reorganization is both (i) objectively futile and (ii) filed in subjective bad faith." *Carolin, supra,* 886 F.2d at 706.

Judge Whitley recognized that some courts hold that either objective futility or subjective bad faith is sufficient, but "the Fourth Circuit demands both."

Judge Whitley mentioned *Official Committee of Asbestos Claimants v. Bestwall LLC (In re Bestwall LLC)*, 71 F.4th 168 (4th Cir. June 20, 2023), as a "factually similar Texas Two-Step asbestos reorganization case." To read ABI's report, click here. In *Bestwall*, he said that the "Fourth Circuit . . . did not see any objective futility in such a debtor filing bankruptcy."

In short, the Fourth Circuit's recent recitation of the dual standard means that *Carolin* remains good law. "Because *Carolin* involved a fatally insolvent debtor," he deduced that "the application of its two-prong standard to a case filed by a solvent, financially non-distressed debtor means all such cases survive dismissal, regardless of purpose."


Noting that *Carolin* was decided 35 years ago and that bankruptcies by nondistressed companies are a "rarity," Judge Whitley wondered "whether the *Carolin* majority contemplated that its test would be employed to the cases of solvent, nondistressed corporations."

Should the Fourth Circuit "elect[] to reconsider applicability of the *Carolin* Two-Prong Test in the case of a solvent, non-distressed Chapter 11 debtor," Judge Whitley said that the appeals court might view the case as a bad faith filing if the debtor is not "financially distressed."

"For now," Judge Whitley said, "*Carolin* is controlling precedent."

Applying *Carolin*

As a "last gasp," Judge Whitley described the movants as arguing that the reorganization was "objectively futile" because the debtor had no business to operate. Going back more than 30 years, he found "no reported case [that] supports the [movants'] theory that objective futility exists due to the lack of a business to rehabilitate."

Indeed, Judge Whitley said that the case was "quite like" *Bestwall*, where the Fourth Circuit "did not see any objective futility in such a debtor filing bankruptcy. *Bestwall*, 71 F.4th at 182."

Finding no other grounds for dismissal under Section 1112(b), Judge Whitley denied the motion to dismiss, saying that "these cases are not 'bad faith' filings under the controlling *Carolin* test."

Scholarly Commentary

Prof. Brubaker provided ABI with the following commentary:

> This is an extremely thoughtful opinion that is obviously very sympathetic to all of the movants' arguments: both on the bad-faith filing issue and regarding the constitutionality of an eminently solvent, non-distressed defendant using bankruptcy as a means of imposing on nonconsenting claimants a mandatory no-opt-outs settlement of (that places a judicially approved hard cap on) its aggregate mass-tort liability.
>
> Judge Whitley ultimately determines that there is no constitutional bar on such an entity filing bankruptcy, but he expressly holds open the question of whether such an entity can constitutionally bind nonconsenting claimants to a plan of reorganization that would purport to extinguish their ability to litigate their claims and recover in full through the nonbankruptcy tort system.


Prof. Brubaker is the James H.M. Sprayregen Professor of Law at the University of Illinois College of Law. The professor wishes to disclose that he is a consultant to counsel for one of the participants in a pending Texas Two-Step mass-tort bankruptcy case and that the views expressed are solely his own.

The opinion is *In re Aldrich Pump LLC*, 20-30608 (Bankr. W.D.N.C. Dec. 28, 2023).


# *Executory Contracts & Leases*


***Across the board, the district court affirmed a decision by Bankruptcy Judge Michael Wiles that minimized landlords' claims resulting from lease termination or rejection.***

# District Court Upholds the 'Time Approach' to Reduce Landlords' Claims

Affirming Bankruptcy Judge Michael E. Wiles across the board, District Judge Mary Kay Vyskocil of New York laid down a set of rules interpreting Section 502(b)(6)(A) to minimize the claims of lessors of commercial real estate.

The chapter 11 debtor was an owner of department stores. A nondebtor affiliate leased real property. The debtor guaranteed the lease and provided a $7.6 million letter of credit to secure the guarantee. After filing, the affiliate vacated the premises and turned the keys over to the landlord.

The landlord refused to accept termination of the lease but drew down the letter of credit. As the months passed, the landlord applied the proceeds to the rent as it was coming due. The landlord filed a $44.4 million proof of claim on the guarantee, to which the debtor objected.

In his decision in February 2023, Bankruptcy Judges Wiles made several important rulings in favor of the debtor. Among other things, Judge Wiles held that the so-called "time approach" is applied to reduce a landlord's claims under the cap contained in Section 502(b)(6)(A). *In re Cortlandt Liquidating LLC*, 648 B.R. 137 (Bankr. S.D.N.Y. Feb. 2, 2023). To read ABI's report, click here.

The landlord appealed but lost on every issue decided by Judge Vyskocil in her March 26 opinion. Judge Vyskocil was a bankruptcy judge in New York from 2016 until her elevation to the district court in late 2019.

## The Cap Applies to Lease Guarantors

Most of the issues on appeal turned on the interpretation of Section 502(b)(6)(A). The subsection limits a claim "for damages resulting from the *termination of a lease* of real property" to "(A) the rent reserved by such lease, without acceleration, *for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease*, following the earlier of — (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; . . . ." [Emphasis added.]


The landlord argued that Section 502(b)(6)(A) did not apply because it was not making a claim against a lessee but, rather, against a guarantor. Judge Vyskocil conceded that "the statute does not explicitly address whether it applies with respect to a claim against a *guarantor*/debtor of a lease as opposed to a tenant/debtor." [Emphasis in original.]

To decide whether the cap applied to a guarantor of a lease, Judge Vyskocil noted how "the goal behind the statutory damages cap is to compensate a lessor for his damages, while at the same time ensuring that the landlord's claim is not permitted to be so large that other general unsecured creditors are unable to get recovery from the estate."

Siding with the "overwhelming majority of courts," Judge Vyskocil held that "the Section 502(b)(6) Cap applies to a lease guarantor."

The Lease Was Terminated, to Make Section 502(b)(6)(A) Applicable

The landlord submitted that the cap was not applicable because the cap applies to a "termination of a lease," and the lease had not terminated under state law.

Judge Vyskocil said there was "no case law" defining the word "termination" as used in Section 502(b)(6). She found no clear error in the bankruptcy court's finding that the lease was "functionally dead" when the affiliate vacated.

With no binding precedent, Judge Vyskocil held the cap applicable, because "it would be antithetical to the purpose of Section 502(b)(6) to allow a landlord to avoid application of the damages cap by seizing on a technicality in state law to refuse to accept a surrender of the premises after the lessee has intentionally abandoned the premises."

The 'Time' Approach or the 'Rent' Approach?

For a claim on a long-term lease, Bankruptcy Judge Wiles ruled that the so-called time approach applies to the calculation of a lessor's claim. The time approach counts the greater of 15% or three years of rent due after the filing of the petition. The rent approach takes rent escalations into account by computing the greater of 15% or three years of rent over the duration of the lease.

Judge Vyskocil said there was a "clear divide" among district courts in deciding which approach to apply. She cited *Collier* and other treatises for now adopting the time approach. Saying that Bankruptcy Judge Wiles had written a "well-reasoned decision," she upheld the time approach in view of the "plain language" of the statute, which "speaks in terms of time and not dollar amounts."

The LC Reduced the Claim


The landlord argued that the drawdown of the letter of credit should not reduce the claim, after application of the cap.

Judge Vyskocil upheld the bankruptcy court's finding of "uncontroverted evidence" that the letter of credit had been "satisfied" with estate assets under the chapter 11 plan. If the drawdown did not reduce the claim, she said that a holding to that effect "would lead to duplicate claims against the Debtors from [the landlord] and [the bank that issued the letter of credit]."

Judge Vyskocil held "that the Letter of Credit should be deducted from [the landlord's] Claim after the Section 502(b)(6) calculation is complete."

Cleanup Charges Are Subject to the Cap

Part of the landlord's claim involved cleanup charges after the affiliate vacated. The bankruptcy court made cleanup costs subject to the cap.

Judge Vyskocil explained how Bankruptcy Judge Wiles followed *Saddleback Valley Cmty. Church v. El Toro Materials Co. (In re El Toro Materials Co.)*, 504 F.3d 978 (9th Cir. 2007), where the Ninth Circuit asked whether the landlord would have the same claim had the lease been assumed.

"Finding no controlling case law to the contrary and finding other Southern District of New York cases that have similarly applied the *El Toro* test," Judge Vyskocil saw "no error in the Bankruptcy Court's application of the *El Toro* test to determine whether certain damages arose 'from the termination' of a Lease."

Because the cleanup costs arose from the termination of the lease, Judge Vyskocil held that the costs were subject to the cap.

The opinion is *Lincoln Triangle Commercial Holding Co. LLC v. Halpern (In re Cortlandt Liquidating LLC)*, 23-03262 (S.D.N.Y. March 26, 2024).


***If a breach results only in a right to equitable relief, there is no 'claim' and thus no executory contract.***

# Noncompete and Confidentiality Agreements Can't Be Rejected as Executory Contracts

Even though a franchise agreement was rejected as an executory contract, Bankruptcy Judge Joel D. Applebaum of Flint, Mich., explained why noncompetition and confidentiality agreements remained enforceable.

The debtor purchased an auto repair shop that had been operating for 15 years under a franchise agreement with a franchisor of similar businesses in the region. The debtor and its owner each signed a franchise agreement containing a noncompetition agreement. The debtor and the owner also signed a separate confidentiality agreement.

In Subchapter V of chapter 11, the debtor filed a motion to reject the franchise agreement, the noncompetition agreement and the confidentiality agreement. The franchisor conceded that the franchise agreement was an executory contract subject to rejection but took the position that the confidentiality and noncompetition agreements could not be rejected.

The franchisor won in an opinion by Judge Applebaum on April 26.

On the merits, Judge Applebaum began by analyzing whether the three agreements were executory contracts. He cited the Supreme Court for the idea that contracts are executory if performance remains on both sides. *See NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 522, n.6 (1984).

Because rejection of an executory contract is a "breach of contract" under Section 365(g)(1) "immediately before the date of filing of the petition," Judge Applebaum said he was required to "determine the nature of any damages arising from the breach."

Next, Judge Applebaum cited the Sixth Circuit for the notion that equitable relief is not a "claim" if it's "an alternative to a right to payment." *Kennedy v. Medicap Pharmacies, Inc.*, 267 F.3d 493, 497 (6th Cir. 200). He quoted the *Collier* treatise: "'Most courts have concluded that a covenant not to compete, or at least the portion of such a contract giving a right to injunctive relief, is not a claim.'"


Judge Applebaum also cited a case from the Sixth Circuit where the debtor was subject to a covenant not to compete that was part of a franchise agreement. The bankruptcy court had modified the automatic stay, allowing the franchisor to pursue injunctive relief in state court.

The Sixth Circuit affirmed, holding that the right to injunctive relief was not a claim "because compliance with the injunction required only that the debtors cease violating the terms of the non-compete agreement going forward." *Kennedy v. Medicap Pharmacies, Inc.*, 267 F.3d 493, 497 (6th Cir. 2001).

Admitting that the franchise agreement was an executory contract subject to rejection, the franchisor contended that the noncompetition and confidentiality agreements were not executory because equitable relief was the remedy.

Judge Applebaum focused on the damages provisions in the three contracts. The franchise agreement called for monetary damages calculated by formula, making the franchise agreement a rejectable executory contract.

In the event of breach, the confidentiality agreement called for injunctive relief because, it said, damages would be "incalculable." Thus, the confidentiality agreement could not be rejected. Likewise, Judge Applebaum said that "the equitable remedies contained in the [noncompetition agreement] and the Confidentiality Agreement cannot be reduced to a monetary claim and remain enforceable by [franchisor]."

"While a monetary claim based upon the liquidated damages formula may compensate for lost royalty payments, this provision does not (nor was it intended to) protect [the franchisor's] trademarks, confidential intellectual property and customer goodwill," Judge Applebaum said. "Accordingly," he held that "the equitable relief at issue in this case is not simply an alternative to a right of payment and, therefore, cannot be reduced to a monetary claim under 11 U.S.C. § 101(5)(B)."

Judge Applebaum allowed rejection of the franchise agreement. As to the other two agreements, he held:

> The non-compete clause in the Franchise Agreement remains enforceable post-rejection. Moreover, the separate Confidentiality Agreement is not an executory contract subject to rejection and, therefore, that agreement also remains enforceable.

The opinion is *Empower Central Michigan Inc.*, 23-31281 (Bankr. E.D. Mich. April 26, 2024).


# *Venue, Jurisdiction & Power*


***Some authority from the Supreme Court suggests that a contempt order without imposition of attorneys' fees would not be final in a bankruptcy case.***

# Finality of a Contempt Order Drawn into Question in the Eleventh Circuit

In a case involving the finality of a contempt order for violating the automatic stay, a judge on the Eleventh Circuit hints that her circuit's precedent may be out of step with Supreme Court authority.

Bound by its own precedent, the Eleventh Circuit held that an order in a contempt proceeding is nonfinal and nonappealable until the bankruptcy court fixes the award of attorneys' fees in later proceedings. Relying on earlier Supreme Court's authority, the district court believed that the appeal should have been taken immediately after the contempt finding, although damages and attorneys' fees were left open at the time.

Contempt and Attorneys' Fees

Before bankruptcy, the corporate debtor had been suing a local government for disclosure of documents under the state's public records act. The debtor and the city settled but left open the question of whether the debtor was entitled to costs and attorneys' fees.

The day before the hearing in state court on attorneys' fees, the debtor filed a chapter 11 petition. The debtor argued in state court that the automatic stay precluded a hearing on its own fee request.

The city countered in state court by contending that the automatic stay did not apply because the debtor was on the offensive. The state court agreed with the city but decided to withhold a ruling on attorneys' fees until the conclusion of the bankruptcy.

Six weeks after the hearing in state court, the debtor moved in bankruptcy court to hold the city in contempt of the automatic stay. The bankruptcy court disagreed with the state court and held that the city had violated the automatic stay.

The bankruptcy court entered an order finding the city in contempt and liable for violating the stay. The contempt order also declared that the city would be liable for the debtor's attorneys' fees in an amount to be decided in further proceedings. The contempt order ruled that the debtor was entitled to neither compensatory nor punitive damages.


The city did not appeal the contempt order.

Weeks later, the bankruptcy court conducted a hearing and held the city liable for about $13,000 in attorneys' fees. The city then appealed both the contempt order and the order granting the debtor $13,000 in attorneys' fees.

The city appealed, presumably to argue under *Taggart v. Lorenzen*, 139 S. Ct. 1795, 1799 (2019), that there was no contempt because the city had an "objectively reasonable basis" for contending there was no violation of the automatic stay.

The district court dismissed the appeal, believing that the appeal from the contempt order was untimely. The city appealed to the Eleventh Circuit.

Conflicting Supreme Court Authority

In her December 5 opinion for the appeals court, Eleventh Circuit Judge Robin S. Rosenbaum said she understood why the district court believed the contempt order was a final order requiring an immediate appeal. "After all," she said, the contempt order "left only the determination of attorneys' fees, so a straight-forward application of the 'bright-line rule' from *Budinich* and *Ray Haluch* yields the conclusion that the Contempt Order was a 'final decision.'"

Judge Rosenbaum was referring to *Budinich v. Becton Dickinson & Co.*, 486 U.S. 196, 199 (1988), where she characterized the Supreme Court as holding under 28 U.S.C. § 1291 that "an outstanding attorneys' fees issue does not preclude an otherwise final decision from being a 'final decision.' *Budinich*, 486 U.S. at 202."

Judge Rosenbaum's other reference was to *Ray Haluch Gravel Co. v. Cent. Pension Fund of Int'l Union of Operating Eng'rs and Emps.*, 571 U.S. 177 (2014), where she said the Supreme Court reaffirmed the *Budinich* principle in a contractual context. In *Ray Haluch*, she described the Supreme Court as holding "that an unresolved attorneys' fee issue did not prevent a decision from being 'final' even though attorneys' fees were part of the contract damages to be awarded. *Id.* at 184–85."

"But this is a contempt case," Judge Rosenbaum said. She cited Eleventh Circuit authority as recently as 2019 for the proposition "that a contempt decision does not become 'final' until the contempt penalties imposed are no longer 'conditional or subject to modification.' *PlayNation Play Sys., Inc. v. Velex Corp.*, 939 F.3d 1205, 1212 (11th Cir. 2019) (citations omitted)."

According to Judge Rosenbaum, *PlayNation* and cases like it in the Eleventh Circuit, such as *Combs v. Ryan's Coal Co., Inc.*, 785 F.2d 970 (11th Cir. 1986), were based on *Fox v. Capital Co.*, 299 U.S. 105 (1936).


Judge Rosenbaum was obliged to deal with the question of whether *Combs* and *PlayNation* were not good law in view of Supreme Court edicts in *Budinich* and *Ray Haluch*. She cited the familiar proposition that a circuit court must follow its own precedent, like *PlayNation*, unless the *en banc* court or the Supreme Court abrogates it. "Here," the judge said, "we issued *PlayNation* after the Supreme Court issued its decisions in *Budinich* and *Ray Haluch*. That means *PlayNation* controls."

Judge Rosenbaum said that *PlayNation* was "materially indistinguishable" from the case on appeal and required reversal of the district court, because the contempt order did not become final until the amount of attorneys' fees was fixed. She vacated the district court decision and remanded, presumably for the district court to consider whether *Taggart* precluded a contempt finding.

Observations

There is a lack of clarity as to whether a contempt order is final before the bankruptcy court determines the amount of damages and attorneys' fees. Courts typically seem to believe that attorneys' fees are integral and not subsidiary to the contempt claim, meaning there is no final order until attorneys' fees are fixed.

The Supreme Court's decision in *Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015), does not answer the question definitively. In *Bullard*, the Court held that an order denying confirmation of a chapter 13 plan was not final and not appealable. *Bullard* instructs courts to identify the "relevant proceeding."

In the context of a bankruptcy proceeding for contempt, what's the relevant proceeding? Is it purely the finding of contempt, or is contempt inextricably bound with the debtor's damages and attorneys' fees? And what if the court fixes the debtor's damage but does not immediately rule on attorneys' fees?

One day, an appellate court in a bankruptcy case may cite *Budinich* and *Ray Haluch* to hold that a contempt finding unadorned by attorneys' fees is final. Caution therefore counsels the filing of an appeal immediately after a finding of contempt. Courts could clarify finality by entering a memorandum opinion that finds contempt but withholding entry of an order until fixing the amount of damages and attorneys' fees.

The opinion is *Sweetapple v. Asset Enhancement Inc. (In re Asset Enhancement Inc.)*, 22-11389 (11th Cir. Dec. 5. 2023).


***Three Eleventh Circuit Judges would have their appeals court sit en banc to stop dismissing for lack of standing when dismissal should be resulting from failure to state a claim under state law.***

# The Eleventh Circuit Rails Against 'Prudential Standing'

Picking up where the Supreme Court left off in *Lexmark* when it decried the use of "prudential standing," three judges on the Eleventh Circuit said that the district court should have dismissed for failure to state a claim rather than having dismissed a receiver's tort claims for lack of standing. *See Lexmark Int'l, Inc. v. Static Control Components, Inc.*, 572 U.S. 118 (2014).

The appeals court explained in a concurring opinion by all three judges that the distinction is more than semantic. Lack of standing results in dismissal for lack of Article III subject matter jurisdiction and therefore ordinarily requires dismissal without prejudice.

When the plaintiff has no claim under state law, dismissal is ordinarily with prejudice, the appeals court said.

The Florida Ponzi Scheme

A group of affiliated companies conducted a $78 million Ponzi scheme that defrauded 700 investors who thought it was a legitimate foreign exchange trader. When the fraud was uncovered, the CFTC and the Justice Department jumped in and shut down the business. Two individuals were convicted and are serving lengthy prison sentences.

The federal district court appointed a receiver for the companies. The receiver filed suit against an individual who was a majority owner and a director. The suit made claims against the owner for fraudulent transfers under Florida law and for common law tort claims, likewise under Florida law.

The lawsuit alleged fraudulent transfer claims against the broker through which the fraudsters had been making foreign exchange trades. The complaint had common law tort claims against the broker, the owner and a software developer, who allegedly aided in sending false statements to the investors.


The district court dismissed the claims across the board, reasoning that the receiver lacked standing to bring both fraudulent transfer and tort claims against all defendants. The receiver appealed.

The Opinion for the Court on Fraudulent Transfer

Writing for the appeals court in his March 19 opinion, Circuit Judge William Pryor said that a "federal equity receiver appointed in the wake of a Ponzi scheme stands in the shoes of the Ponzi estate." He went on to say that the "receiver has standing to complain about the injuries that the Ponzi entities suffered, not the injuries of the investor-victims," citing the Eleventh Circuit's opinion in *Isaiah v. JPMorgan Chase Bank, N.A.*, 960 F.3d 1296, 1306 (11th Cir. 2020).

According to Judge Pryor, it "is well-settled that a receiver for a Ponzi estate has standing to maintain fraudulent-transfer claims on behalf of the estate." *Id*. He traced the rationale of *Isaiah* to a Seventh Circuit Decision by Richard A. Posner, *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995). He paraphrased Judge Posner as having held:

> When the perpetrators are removed and a receiver is appointed in their place, the corporate structures are no longer the "evil zombies" of the perpetrator; they are "[f]reed from his spell" and regain standing to sue for the return of money fraudulently transferred. *Id.*

In dismissing the fraudulent transfer claims, Judge Pryor said that the district court cited *Isaiah* but failed to recognize the distinction between tort and fraudulent transfer claims. He explained that *Isaiah* dismissed tort claims for lack of standing. He said that "Ponzi receivers must meet additional criteria to have standing to maintain tort claims against third parties."

Judge Pryor reversed dismissal of the fraudulent transfer claims and remanded for further proceedings. He explained:

> After [the companies were] freed from the control of [the fraudsters] and [the receiver] was appointed in their place, [the companies] regained standing to assert fraudulent-transfer claims.

The Opinion for the Court on Tort Claims

With regard to the receiver's tort claims, Judge Pryor said that *Isaiah* also controls. He said that *Isaiah*, which involved tort claims arising from a Ponzi scheme, held that the receiver lacked standing because the torts were imputed to the receiver.

Judge Pryor said that *Isaiah* "also explained that tort and fraudulent-transfer claims must be treated differently for standing purposes: fraudulent transfers are 'cleansed through receivership'


as a matter of course, but common-law torts by third parties are not." He went on to explain that a receiver would have standing to bring tort claims if it were an "'honest corporation[] with rogue employees.'" *Isaiah, supra* at 1308.

To have standing, Judge Pryor said that "the receiver must allege the presence of innocent decision-makers within the corporation to whom fraudulent conduct could be reported." *Id*. at 1307.

In the case on appeal, the receiver alleged that the companies were wholly controlled by the fraudsters and were not honest companies with rogue employees.

Judge Pryor reversed dismissal of tort claims with prejudice and remanded with instructions to dismiss without prejudice.

The Concurring Opinion

Circuit Judge Stanley Marcus penned a concurring opinion joined by the other two judges on the panel. He said, "I join in full the Court's opinion and agree that our precedents compel the conclusion that [the receiver] lacked standing to bring his Florida common-law tort claims."

Judge Marcus said he was writing "separately to explain that I think this use of the term 'standing' is mistaken." He explained that standing is an Article III concept of subject matter jurisdiction that requires the existence of a case or controversy. Citing *Lexmark*, he said that "the Supreme Court has walked back the concept of 'prudential standing.'"

Quoting an Eleventh Circuit opinion after *Lexmark*, he said that the Supreme Court "'effectively abolished prudential standing (sometimes referred to as statutory standing) as a jurisdictional doctrine that would give rise to a Rule 12(b)(1) dismissal without prejudice.' *Newton v. Duke Energy Fla., LLC*, 895 F.3d 1270, 1274 n.6 (11th Cir. 2018)." He explained the practical difference between a dismissal for lack of standing and a dismissal for failure to state a claim:

> A dismissal for failure to state a claim is a merits decision and is generally made with prejudice, barring the plaintiff from bringing the same suit again. *See* Fed. R. Civ. P. 41(b). A dismissal for lack of standing, on the other hand, is a non-merits decision and so is generally without prejudice and does not have any preclusive effect.

Judge Marcus called *Isaiah* "the type of mistaken jurisdictional holding the Supreme Court has eschewed. *Isaiah* reasoned that a Ponzi corporation did not have standing to sue for Florida common-law torts." Under Florida law, he went on the explain that a receiver for a Ponzi scheme has standing to sue for fraudulent transfers but not for torts. He explained that the "receiver is


without a cause of action [for tort] precisely because the Florida courts have so ruled, not because the receiver lacks Article III standing."

"Still," Judge Marcus said, "we have unambiguously characterized the rule that a receiver may not bring Florida common-law tort claims on behalf of a Ponzi corporation as jurisdictional." Saying that "we remain bound by decisions we disagree with," he said it "would be wiser to follow the Supreme Court's instruction to 'bring some discipline' to the use of jurisdictional language, and to recognize that rules like this one do not constrain a court's power to hear a case, but rather reflect a state court's decision to police its own causes of action." [Citation omitted.]

The opinions are in *Wiand v. ATC Brokers Ltd.*, 22-13658 (11th Cir. March 19, 2024).


***The Fourth Circuit says that bankruptcy courts have broader jurisdiction than other federal courts and that some of their decisions are unreviewable by Article III courts.***

# 4th Circuit: Bankruptcy Courts Aren't Bound by Case or Controversy Requirements

The Fourth Circuit ruled that bankruptcy courts "can constitutionally adjudicate cases that would be moot if heard in an Article III court." More generally, the appeals court said that bankruptcy courts "are essentially unencumbered by Article III's case-or-controversy requirement." The extraordinary statements by the appeals court may or may not be *dicta*.

The September 14 decision by Circuit Judge Julius N. Richardson could be read to mean that the judicial power of bankruptcy and magistrate judges extends beyond constraints in the constitution limiting federal courts to the adjudication of "cases" or "controversies." If followed elsewhere, the decision also means that decisions by bankruptcy courts in some circumstances may be unreviewable on appeal.

In a footnote, Judge Richardson suggested that the delegation of bankruptcy powers to non-Article III courts may in itself be unconstitutional. If it were so, the same would be true of magistrate judges.

Following discussion of the opinion, we offer commentary by Kenneth N. Klee and Richard B. Levin, both of whom believe the decision was wrongly decided.

## The Dischargeability Complaint

A husband and wife hired a contractor to renovate their home. Dissatisfied with results of the work, the couple learned that the contractor was not licensed. They sued in a Superior Court in Washington, D.C., to recover almost $60,000 they had paid the contractor.

While the suit was pending, the contractor filed a chapter 7 petition in Alexandria, Va. The couple filed a proof of claim for the $60,000 and, separately, a two-count complaint. One count sought a declaration regarding the validity of the alleged $60,000 debt, and the second sought a declaration that the debt was nondischargeable.

Without ruling on the validity of the debt, the bankruptcy court held that the debt was dischargeable and dismissed the count on dischargeability. The count regarding validity of the debt


remained for later adjudication, meaning that the ruling on dischargeability was not a final order subject to appeal.

Judge Richardson said that the debtor and the couple wanted appellate courts to rule on dischargeability "before deciding whether they should expend the resources to litigate the [validity of the] debt."

"So," Judge Richardson said, they "struck a deal" where the couple voluntarily dismissed the count regarding validity of the debt *without prejudice*, aiming to create a final, appealable order regarding dischargeability. On appeal, the district court upheld the bankruptcy court on dischargeability. The couple appealed to the Fourth Circuit.

Manufactured Finality

Judge Richardson cited Fourth Circuit authority for the proposition that "parties cannot collude to create finality after the fact through a voluntary dismissal without prejudice." *Waugh Chapel S. v. United Food and Com. Workers Union Local 47*, 728 F.3d 354, 359 (4th Cir. 2013). He then proceeded to analyze whether the order was indeed final and said that the "appropriate procedural unit for determining finality here is the adversary proceeding."

Judge Richardson said that the "bankruptcy court's order [before dismissal of the count on validity of the debt] was thus not final when entered" because "an order dismissing only one claim in a multi-claim adversary proceeding does not amount to a final order."

Quoting the Fourth Circuit, Judge Richardson said that the parties "cannot 'use voluntary dismissals as a subterfuge to manufacture jurisdiction for reviewing otherwise non-appealable, interlocutory orders.'" *Waugh, supra,* 728 F.3d at 359.

If the circuit were to allow an appeal on dischargeability, Judge Richardson said "there would be nothing to stop them from reinstating — and then separately appealing — [the count regarding validity of the claim] down the line." He therefore held that "the voluntary dismissal did not make the bankruptcy court's earlier, partial dismissal final," because the count related to validity of the debt "was still very much alive."

The Adversary Proceeding Wasn't Moot

The couple characterized the complaint as seeking authority to pursue collection of the debt outside of bankruptcy. Once the bankruptcy court decided that the debt was dischargeable even if valid, the couple contended that the count in the adversary proceeding regarding validity of the debt became moot because they could not win "any effectual relief" to pursue the debt outside of bankruptcy. Mootness of the validity count, according to the couple, meant that the order on the remaining count about dischargeability was final.


Evidently, Judge Richardson believes there's no such thing as mootness in bankruptcy court.

"Mootness is an Article III doctrine, and bankruptcy courts are not Article III courts," Judge Richardson said. Because bankruptcy courts are not Article III courts, he cited *Stern v. Marshall* for the idea that "they do not wield the United States's judicial Power." Therefore, he said, bankruptcy courts "can constitutionally adjudicate cases that would be moot if heard in an Article III court."

While a bankruptcy case must satisfy Article III standards when referred by district courts to bankruptcy courts, Judge Richardson said that Article III must again be satisfied when the case returns to district court. However, "that limit on the district court's authority does not constrain the bankruptcy court. *Once a case is validly referred to the bankruptcy court, the Constitution does not require it be an Article III case or controversy for the bankruptcy court to act.*" [Emphasis added.]

Having ruled that Article III does not constrain bankruptcy courts, Judge Richardson next considered whether statutes preclude bankruptcy courts from deciding matters that are moot.

Judge Richardson cited Section 157(b)(1) for saying that bankruptcy courts may hear and determine "all" bankruptcy cases and "all" core proceedings, "[n]ot just those that could be fully adjudicated in district court."

Article III constraints, such as mootness, "do not apply to [bankruptcy courts] as a matter of constitutional law," Judge Richardson said. "They only apply," he said, "if Congress said so in a statute." Finding no statute, he held that the "bankruptcy court could still adjudicate it."

Judge Richardson held that voluntary dismissal of count for validity of the debt "did not create a final order under § 158(a)" because dismissal was without prejudice, making the claim "legally viable." He vacated and remanded the order of the district court, because it had "reviewed a non-final order."

In the last paragraph of his decision, Judge Richardson said that bankruptcy courts "are essentially unencumbered by Article III's case-or-controversy requirement."

Commentary

The opinion presents essentially two holdings: (1) Parties may not manufacture finality, and (2) Article I tribunals are not encumbered by the limitations on justiciability imposed by Article III.


The first holding is a reiteration of *Waugh*. Notably, however, the Fourth Circuit in *Waugh* cited the black letter law but proceeded to follow the Eighth Circuit which held that the appeals court could "deem ambiguous voluntary dismissal . . . to be with prejudice" and consider the merits of the appeal. *Waugh*, *supra*., 728 F.3d at 359.

The second holding has broad implications. If adopted in other circuits, bankruptcy courts could rule on disputes that have become moot, and the rulings would be immune from appellate review. Question: Would rulings of the sort be entitled to *res judicata* or collateral estoppel effect in state or federal courts?

The second holding would also seem to mean that bankruptcy court may issue advisory opinions.

To this writer, it's a close call on whether the second holding is *dicta*.

Although not constrained by the Constitution to avoid ruling on moot questions or advisory opinions, may bankruptcy courts in the Fourth Circuit nonetheless abstain?

In the Fourth Circuit, magistrate judges similarly would not be constrained by Article III justiciability standards. One assumes that magistrate and bankruptcy judges would both abstain from exercising jurisdiction beyond the limits of Article III, if authorized to do so.

Constitutionality of the Bankruptcy System

After ruling that bankruptcy courts may constitutionally adjudicate cases that would be moot in Article III courts, Judge Richardson wrote a footnote saying:

> The harder question may be whether [bankruptcy courts] can constitutionally adjudicate cases that are within the judicial power and so could be heard in Article III courts.

To the writer, the quotation seems to suggest that the reference of bankruptcy power to bankruptcy courts may be unconstitutional. However, Judge Richardson said in the footnote that "we need not dive into this question."

Scholarly Commentary

Kenneth N. Klee provided ABI with the following commentary:

> Because the bankruptcy court is not actually a court at all but is a unit of the United States District Court, it is inconceivable to me that the jurisdiction of a non-tenured judge could be greater than that of a tenured judge.


> The jurisdiction is derivative. That's what the concept of withdrawal of the reference is all about. I understand that to a small, uninformed mind, one could reason that the constraints of Article III don't apply to a non-Article III judge, but the notion that by referring matters to non-tenured judges, you can expand jurisdiction is somewhat absurd. Even more so in the criminal context with magistrate judges.

Richard B. Levin provided ABI with the following commentary:

> In my view, the dischargeability determination mooted [the count regarding validity of the debt], even though it did not moot the proof of claim. The proof of claim seeks to share in the estate; the adverse party is the trustee, not the debtor.
>
> [The count on validity of the debt] seeks to collect from the post-discharge debtor, which becomes a moot case once the debt is declared dischargeable. But the [proof of claim] is still live, unless perhaps it's a no-asset case, but that does not affect the mootness (or not) of the count I claim against the debtor [seeking a declaration regarding validity of the debt].
>
> Therefore, the dismissal of [the count regarding validity of the debt] rendered the order final, as in the *Affinity Living Group* case the court cites, and the district court and the court of appeals should have had jurisdiction over that final order.
>
> The only way the Article III courts did not have finality jurisdiction was if the case was not moot in the bankruptcy court or, as the court of appeals puts it, if the bankruptcy court could still adjudicate the case even though it became moot. (Of course, why would anyone want to adjudicate a moot case? That was the parties' point in their stipulation.)
>
> Therefore, the Article III language in the court of appeals opinion is not *dicta*; it is holding. It was necessary to the decision, which makes it even more troubling than if it were *dicta*. In short, I think the court did not really understand the court and jurisdictional system that Congress set up after *Marathon*.
>
> Another troubling part of this decision, even though not so troubling as the Article III point, which would give the bankruptcy courts unreviewable authority over a whole range of moot and advisory issues, is that the decision effectively requires parties to keep fighting over something that doesn't matter so they can appeal something that does matter.


Messrs. Klee and Levin were counsel for committees in the House and Senate and were among the principal draftsmen of the Bankruptcy Code and the Bankruptcy Reform Act of 1978. Mr. Klee is partner emeritus at KTBS Law LLP in Los Angeles, and Mr. Levin is a partner with Jenner & Block LLP in New York City.

Further Commentary

This writer believes that the Fourth Circuit may have reached the right result for the wrong reason.

Was it a subterfuge to dismiss the count in the complaint on validity of the debt while leaving proof of claim alive in the claims register? Doesn't survival of the proof of claim mean that the creditors had not in reality dismissed the count based on the alleged debt?

This writer submits that the appeal court could have and perhaps should have ruled that survival of the proof of claim in itself kept disposition of the adversary proceeding from becoming a final order. Focusing on the implications arising from the proof of claim would have obviated the need to discuss the bankruptcy court's lack of constraints under Article III.

This writer hopes that someone files a petition for rehearing *en banc*, permitting scholars to submit *amicus* briefs regarding Article III constraints on bankruptcy and magistrate judges.

The opinion is *Kiviti v. Bhatt*, 22-1216 (4th Cir. Sept. 14, 2023).


***The 'broad' definition of 'claim' by the Supreme Court in Johnson led Judge Huennekens to hold that in rem rights against a debtor's property give rise to a 'claim.'***

# Even Without Personal Liability, a Mortgage on a Debtor's Property Is a 'Claim'

Even when the debtor has no personal liability on a mortgage secured by investment property, a chapter 13 plan may modify the mortgage, according to Bankruptcy Judge Kevin R. Huennekens of Richmond, Va.

Judge Huennekens based his decision on the "broad" definition given to "claim" by the Supreme Court in *Johnson v. Home State Bank*, 501 U.S. 78 (1991).

The debtor had inherited real property encumbered by a $56,500 mortgage at the time he filed a chapter 13 petition. The mortgage debt included about $8,500 in arrears.

The debtor filed a plan to retain the property, pay the arrears over 34 months and make post-petition payments directly to the mortgagee. The debtor conceded that he was not in privity with the mortgagee and that he had no personal liability on the mortgage.

The lender objected to the plan, contending that the debtor had no right to cure the mortgage defaults in the plan because the mortgage did not represent a "claim" against the debtor. Judge Huennekens said that the Fourth Circuit has not decided whether *in rem* rights alone represent a "claim."

Indeed, Judge Huennekens said "there is a split of authority as to whether a Chapter 13 plan may cure a defaulted secured claim when no privity of contract exists between the debtor and the creditor." The majority, he said, invoke the "broad" definition given to a "claim" by *Johnson* and permit cure. The minority interpret "claim" narrowly and say that no claim exists without personal liability.

The word "claim" is defined in Section 101(5). In part, "claim" means a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."

Judge Huennekens explained that *Johnson* involved a debtor who aimed for the plan to pay a secured claim even though the debtor's personal liability had been discharged in a prior chapter 7


case. He described the Supreme Court as having "determined that the secured claim that survived the discharge of a debtor's personal liability was a 'claim' within the meaning of section 101(5) of the Bankruptcy Code. *Johnson*, 501 U.S. at 84."

Through the adoption of Section 101(5), Judge Huennekens said that the Supreme Court in *Johnson* decided that "Congress intended to adopt the broadest possible available definition of 'claim.' *Id*. at 83."

From *Johnson*, Judge Huennekens held that "the creditor has a 'claim' that may be included in a Chapter 13 plan 'if it is enforceable against *either* the debtor *or* his property.' *Id*. at 85." [Emphasis in original.]

Unable to distinguish *Johnson*, Judge Huennekens decided that the plan could cure arrears on the mortgage "under the broad definition provided in section 101(5)." Furthermore, the debtor had the right under Section 1322(b)(2) to modify the rights of holders of secured claims.

Because the lender had a secured claim, Judge Huennekens overruled the objection and held that the plan could modify the claim under Section 1322(b)(2).

The opinion is *In re Stevenson*, 23-32811 (Bankr. E.D. Va. Nov. 8, 2023).


***Ninth Circuit says that the 'person aggrieved' standard for appellate standing was superseded by Article III standing on adoption of the Bankruptcy Code in 1978.***

# 'Person Aggrieved' Isn't the Proper Standard for Bankruptcy Appeals, Circuit Says

If injury to the appellant is "too conjectural and hypothetical," the Ninth Circuit says there is no appellate standing, even under the less demanding standard for Article III or constitutional standing as opposed to the more exacting "person aggrieved" test.

In his May 8 opinion, Circuit Judge Ryan D. Nelson dismissed the appeal because the chapter 11 plan promised full payment to the appealing creditor. Although the debtor was behind in making plan payments, the injury remained "conjectural at best," given the effusive findings of fact by the bankruptcy court assuring payment in full.

Note: Judge Ryan Nelson is not to be confused with Senior Circuit Judge Dorothy W. Nelson, also of the Ninth Circuit.

The Full Payment Plan

The chapter 11 debtor confirmed a plan promising payment in full, with interest, to unsecured creditors, even to creditors whose claims were subordinated. To assure full payment, the plan was backstopped with a $10 million contribution by a plan proponent. In addition, creditors were given collateral security in the form of a lien on all assets.

Bankruptcy Judge Sheri Bluebond of Los Angeles found that the debtor was emerging from chapter 11 with $23.4 million in net equity in its assets. Judge Nelson said the net equity "far" exceeded the claims to be paid under the plan.

The debtor had been under the command of a chapter 11 trustee. After confirmation, the trustee filed an application for payment of about $1.16 million in compensation, the maximum commission under Section 326(a).

The requested compensation represented about $760,000 at the trustee's usual hourly rate of $450 per hour. The trustee justified the additional $400,000 as an enhancement for "exceptional services."


Bankruptcy Judge Bluebond granted the requested compensation in full, saying that the commission in itself was presumptively reasonable and that the results of the reorganization were exceptional, justifying enhancement over the lodestar.

A subordinated creditor appealed the allowance of the trustee's compensation. The district court held that the creditor was an "aggrieved party" given the possibility of it not being paid in full. On the merits, however, the district court affirmed the award.

The subordinated creditor appealed to the circuit.

The Critique of 'Person Aggrieved'

For appellate jurisdiction, Article III of the Constitution requires the existence of a case or controversy. Judge Nelson said that appellate courts have been imposing the higher "person aggrieved" standard to justify appellate standing in bankruptcy cases.

Judge Nelson's opinion is a lesson in history. He explained how "person aggrieved" was a "prudential requirement" found in the Bankruptcy Act of 1898. It was adopted to restrict appeals to those who would be affected by the outcome.

Although the Bankruptcy Act was repealed in 1978 on adoption of the Bankruptcy Code, Judge Nelson said, "we continued to apply the 'person aggrieved' standard." Moreover, he said:

> It is unclear why we continued to apply the person aggrieved rule in the absence of the statute providing the basis for doing so. We appear to have recast the pre-1978 statutory standard and applied it as a principle of prudential standing.

"But," Judge Nelson said, "the Supreme Court has since questioned prudential standing," finding tension with federal courts' "virtually unflagging" obligation to hear cases within their jurisdictions. *See Susan B. Anthony List v. Dreihaus*, 573 U.S. 149, 167 (2014).

"Still," Judge Nelson said, "our bankruptcy cases have historically addressed prudential standing with little attention to Article III."

No Article III Appellate Jurisdiction

Judge Nelson examined the facts to determine whether the subordinated creditor had Article III standing. The required showing is (1) an "injury in fact" that is concrete, particularized and actual or imminent; (2) an injury "fairly traceable" to the defendant's conduct; and (3) an injury that can be addressed by a favorable decision. The "foremost" requirement is injury in fact, Judge Nelson said.


The subordinated creditor claimed injury because it had not yet been paid in full, and the extra compensation for the trustee diminished the likelihood of full payment. The debtor countered by saying there was no harm because the creditor would be paid in full, the only question being when or how soon.

Judge Nelson examined the plan and the facts in detail. He noted that the plan did not have a limited fund because there was "no finite amount of assets from which all creditors could be paid." Indeed, he said there was a 35% equity cushion protecting the payment of claims in full.

Given that payment in full was assured, Judge Nelson said in substance that any delay in payment would not give rise to injury. He held that the creditor's "alleged injury is too conjectural and hypothetical to establish injury in fact for Article III standing.

Judge Nelson reversed the district court and remanded with instructions to dismiss the appeal for lack of appellate standing.

Equitable Mootness

Judge Nelson's opinion is another indication that the doctrine of equitable mootness would not withstand scrutiny in the Supreme Court.

When a consummated chapter 11 plan is found to be equitably moot, there is typically a case or controversy establishing Article III or constitutional jurisdiction in the appellate court, because the parties disagree about the legal principle underlying the appeal. Equitable mootness is a higher, judge-made standard employed by appellate courts to dismiss appeals when the appellate court nonetheless has jurisdiction.

Judge Nelson's opinion recites the Supreme Court's admonition that courts are obliged to exercise their jurisdiction.

Weaving the notions together, the Supreme Court one day might say that appellate courts must resolve the case or controversy arising from disputed confirmation and remand for the bankruptcy court to identify relief that is available, if any.

The opinion is *Clifton Capital Group LLC v. Sharp (In re East Coast Foods Inc.)*, 21-55967 (9th Cir. May 8, 2023).


***Bankruptcy courts can have subject matter jurisdiction to approve settlements between nondebtors.***

# Fifth Circuit Adheres to 'Person Aggrieved' for Appellate Standing in Bankruptcy

In its fifth and sixth opinions arising from the chapter 11 reorganization of Highland Capital Management LP, the Fifth Circuit reiterated its adherence to "person aggrieved" as the standard for appellate standing and reaffirmed the jurisdiction of the bankruptcy court to approve settlements between nondebtors when the estate is affected.

The appeal on appellate standing was brought by a family trust controlled by Highland's former chief executive, who was removed before the company confirmed a chapter 11 plan. The family trust held a limited partnership interest in the debtor amounting to about 0.2%. The family trust had filed three proofs of claim, but all were withdrawn.

The bankruptcy court in Dallas approved a settlement with a creditor that had filed a claim for more than $300 million. The settlement gave the creditor an approved, unsecured claim for $45 million and a subordinated claim of some $35 million.

## Appellate Standing

The family trust appealed, but the district court dismissed the appeal for lack of appellate standing.

In a nonprecedential, *per curiam* opinion on July 31, the Fifth Circuit reaffirmed its own precedents by saying that the "person aggrieved" standard for appellate standing in bankruptcy cases was employed from "necessity" and is "more exacting" than Article III standing.

To be a "person aggrieved" with prudential standing in a bankruptcy case, the appellant must be directly, adversely and financially impacted by the order on appeal.

The family trust contended that it was an equity holder with standing as a "party in interest" under Section 1109(b) and on account of its three proofs of claim. Summarily, the appeals court said there was no standing from the proofs of claim because they had been withdrawn, "with prejudice."

For its equity interest, the plan put the trust in the eleventh and last class in the waterfall. The debtor said that the debtor's funds would be exhausted by the eighth class. Because the trust's


counsel didn't contest the debtor's representation, the appeals court held that the trust was not "directly" affected and lacked standing.

Because the debtor failed to establish standing as a person aggrieved, the circuit court affirmed dismissal of the appeal.

Jurisdiction over Third-Party Settlements

The former CEO's family trust appealed another order approving a different settlement. Although the facts were more complex, they boil down to this.

A bank asserted a claim against the debtor for more than $1 billion. In a settlement approved by the bankruptcy court, the bank was given an approved, unsecured claim for $65 million and a subordinated claim for $60 million.

The approved settlement also had a third party paying the bank $18.5 million. In addition, the parties exchanged complicated releases.

The family trust appealed, contending that the settlement should have been broken into pieces and that the bankruptcy court had no jurisdiction to approve settlement between nondebtors. The district court upheld approval of the settlement. Appealing to the Fifth Circuit, the family trust again raised the alleged lack of jurisdiction to approve settlement between nondebtors.

In a nonprecedential, *per curiam* opinion on July 28, the Fifth Circuit said that "related to" jurisdiction under 28 U.S.C. § 1334(b) is read "broadly." Jurisdiction is found if the outcome "could conceivably" affect the bankrupt estate, the appeals court said in citing its own precedents. The appeals court went on to say that certainty of effect is "unnecessary."

Without deciding whether the particular matter was "core" or "noncore," the appeals court held that jurisdiction was at least "related to."

The family trust contended that the bankruptcy court needed jurisdiction over the claims between the nondebtors.

The circuit court rejected the argument, citing its own precedent and saying that the bankruptcy court "needed jurisdiction only over the settlement agreement itself and over the parties who entered it, not over the underlying claims."

The appeals court upheld approval of the settlement, saying it was "undoubtedly" related to the bankruptcy since it resolved a claim for more than $1 billion and granted $125 million in approved claims, thereby altering the debtor's rights and liabilities.


Note

In another nonprecedential Highland Capital appeal just a few days earlier in July, the Fifth Circuit had espoused its continuing adherence to "person aggrieved" as the standard for appellate standing. *See NexPoint Advisors LP v. Pachulski Stang Ziehl & Jones LLP (In re Highland Capital Management LP)*, 22-10575, 2023 WL 4621466 (5th Cir. July 19, 2023). To read ABI's report, click here.

The opinions are *Dugaboy Investment Trust v. Highland Capital Management LP (In re Highland Capital Management LP)*, 22-10983 (5th Cir. July 28, 2023); and *Dugaboy Investment Trust v. Highland Capital Management LP (In re Highland Capital Management LP)*, 22-10960 (5th Cir. July 31, 2023).


*The Fifth Circuit declined to follow the Ninth Circuit in questioning 'person aggrieved' as being inconsistent with recent Supreme Court authority.*

**Fifth Circuit Reaffirms 'Person Aggrieved' as the Standard for Appellate Standing**

Where the Ninth Circuit recently questioned whether the "person aggrieved" standard for appellate standing is still good law, the Fifth Circuit reaffirmed the standard, saying that the Supreme Court had only nixed a more demanding prudential standing requirement in cases under the Lanham Act.

After confirmation of a chapter 11 plan, Bankruptcy Judge Stacey G. C. Jernigan of Dallas held a hearing on final allowances of compensation to five professional firms that had served the debtor and the official committee. Alleging to be a creditor by virtue of a disputed administrative claim, the creditor objected to the allowances. The creditor may have been motivated to object because it was a defendant in a pending adversary proceeding.

Bankruptcy Judge Jernigan overruled the objection and granted the allowances. The alleged creditor appealed.

Invoking the "person aggrieved" standard, the district court dismissed the appeal. The alleged creditor appealed to the Fifth Circuit.

In his July 19 opinion, Circuit Judge Patrick E. Higginbotham noted that the bankruptcy court had dismissed the creditor's alleged administrative claim while the appeals were pending on the fee allowances.

'Person Aggrieved' Survives

Judge Higginbotham opened his discussion of the merits by noting how "person aggrieved" was the standard for appellate standing set forth in Section 67(c) of the former Bankruptcy Act. The Act was repealed on adoption of the Bankruptcy Code, but the "person aggrieved" requirement was contained in neither the Code nor Title 28.

"Person aggrieved" requires that the appellant be directly and adversely affected pecuniarily, Judge Higginbotham said. "Person aggrieved" is "more exacting," he said, because it demands a higher causal relationship between the act and the injury than the more flexible Article III standard, known as constitutional standing.

Judge Higginbotham quoted a 2018 Fifth Circuit decision to explain why appellate standing is necessarily more demanding in bankruptcy cases, even after adoption of the Bankruptcy Code:


> Allowing each and every party to appeal each and every order would clog up the system and bog down the courts. Given the specter of such sclerotic litigation, standing to appeal a bankruptcy court order is, of necessity, quite limited.

*In re Technicool Sys., Inc. (In re Technicool)*, 896 F.3d 382, 385 (5th Cir. 2018).

The Merits

Having established that "person aggrieved" survived, Judge Higginbotham examined whether the alleged creditor was aggrieved.

Even if the creditor had an administrative claim, Judge Higginbotham said that the possibility of not being paid was "too remote or speculative" to confer standing. Furthermore, disallowance of the creditor's administrative claim "takes the legs" out from underneath the argument, he said.

The creditor also contended that status as a defendant in an adversary proceeding conferred standing. Judge Higginbotham said that "no less than" seven outcomes would be required before allowance of the fees would "impact" the creditor-defendant.

Having failed to show standing under "person aggrieved," the creditor contended that the standard "did not survive" *Lexmark Int'l, Inc. v. Static Control Components, Inc.* 572 U.S. 118 (2014), where the Supreme Court dealt with standing under the Lanham Act.

The creditor argued that *Lexmark* precludes courts from adopting prudential rules on standing that are stricter than Article III standing.

Judge Higginbotham said that *Lexmark*, which was not a bankruptcy case, did not "unequivocally" overrule Fifth Circuit precedent such as *Technicool*. Even after *Lexmark*, he said that the Fifth Circuit "has repeatedly reaffirmed the 'person aggrieved' standard."

The creditor cited the Ninth Circuit for having abandoned "person aggrieved" in May. *See Clifton Capital Group LLC v. Sharp (In re East Coast Foods Inc.)*, 66 F.4th 1214 (9th Cir. May 8, 2023). To read ABI's report, click here. Judge Higginbotham said that *East Coast Foods* "is not offended by the more exacting 'person aggrieved' metric attending the disposition of bankruptcy claims like the one at issue."

Finally, the creditor argued that it had standing under Section 1109(b), which says:

> A party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.


Judge Higginbotham said that Section 1109(b) "speaks to one's standing to appear and be heard before the bankruptcy court, a concept distinct from standing to appeal the merits of a decision." He cited the *Collier* treatise for saying that "person aggrieved" is the standard for appellate standing, not Section 1109(b).

Judge Higginbotham affirmed the district court for having dismissed the appeal for lack of appellate standing.

The opinion is *NexPoint Advisors LP v. Pachulski Stang Ziehl & Jones LLP (In re Highland Capital Management LP)*, 22-10575 (5th Cir. July 19, 2023).


***The court's ability to compel trial testimony by video doesn't eradicate the 100-mile limitation on issuance of trial subpoenas.***

# Ninth Circuit: Trial Subpoenas Can't Compel Zoom Testimony More than 100 Miles Away

The Ninth Circuit used a bankruptcy case to grant a writ of mandamus and quash a subpoena that would have compelled a witness to testify at trial via contemporaneous video transmission from the witness's home, more than 100 miles from the location of the trial.

In short, the Ninth Circuit won't permit a trial court to use Federal Rule 43(a) to subvert the 100-mile limitation in Federal Rule 45(c)(1). In other words, a subpoena cannot compel a witness to appear and testify at trial via Zoom from a location more than 100 miles from the courthouse.

In her July 27 opinion, Circuit Judge Danielle J. Forrest said it was a "novel issue" that pitted two Federal Rules against one another and has divided the lower courts. The Ninth Circuit, she said, has "not previously addressed the application of Rule 45(c)'s geographical limitations to testimony provided via remote video transmission, which is a question of increasing import given the recent proliferation of such technology in judicial proceedings."

## The Remote Witness

The trustee contended that a potential witness was the source of indispensable testimony to support the trustee's claim in an adversary proceeding pending in bankruptcy court in Los Angeles. The witness lived in the Virgin Islands and refused to appear voluntarily at trial in Los Angeles.

The bankruptcy court authorized the trustee to serve a trial subpoena by certified mail commanding the witness to testify remotely from the Virgin Islands by video transmission. The bankruptcy court denied the witness's motion to quash the subpoena.

The witness moved the bankruptcy court to certify an interlocutory appeal to the district court or the circuit court. The bankruptcy court denied the motion. The witness then filed a petition for mandamus, asking the Ninth Circuit to direct the bankruptcy court to quash the subpoena.

## Mandamus Granted

Judge Forrest granted the petition in an opinion concluding that the 100-mile limitation in Rule 45(c) controls, not Rule 43(a).


Rule 54(c)(1) provides:

> A subpoena may command a person to attend a trial, hearing, or deposition only as follows: (A) within 100 miles of where the person resides, is employed, or regularly transacts business in person.

The second sentence in Rule 43(a) says:

> For good cause in compelling circumstances and with appropriate safeguards, the court may permit testimony in open court by contemporaneous transmission from a different location.

The trustee contended that "compelling circumstances," such as the indispensability of the witness, can justify taking testimony "by contemporaneous transmission from a different location," namely, the witness's home in the Virgin Islands.

Before deciding whether Rule 43(a) would permit trial testimony remotely, Judge Forrest laid out the requirements for the issuance of a writ of mandamus, which she called an "extraordinary remedy" that only issues in exceptional circumstances amounting to judicial usurpation of power or a clear abuse of discretion. The writ, she said, "can be appropriate to resolve novel and important procedural issues."

In the Ninth Circuit, five factors govern the issuance of the writ. *See Bauman v. U.S. Dist. Ct.*, 557 F.2d 650, 654–55 (9th Cir. 1977). The most pertinent for the appeal was the third factor: whether the district court's order was clearly erroneous. Under the differential standard of clear error, Judge Forrest framed the question as "whether Federal Rule of Civil Procedure 45(c)'s 100-mile limitation applies when a witness is permitted to testify by contemporaneous video transmission."

Focusing on Rule 45(c)(1)(A), Judge Forrest said that "the plain meaning of this rule is clear: a person cannot be required to attend a trial or hearing that is located more than 100 miles from their residence, place of employment, or where they regularly conduct in-person business." She said that Bankruptcy Rule 7004(d) incorporates the same limitation.

"Thus," Judge Forrest said:

> we have no difficulty concluding that the [witness] could not be compelled to testify *in person* at a trial in California. The question here is how Rule 45(c) applies when a person is commanded to testify at trial *remotely*. [Emphasis in original.]


The trustee contended that Rule 43(a) circumvents the 100-mile limitation when the testimony is remote because remote testimony moves the "place of compliance" to wherever the witness is located.

To decide which rule dominates, Judge Forrest said that "determining the limits of the court's power to compel testimony precedes any determination about the mechanics of how such testimony is presented."

Consulting the advisory committee notes and drawing an analogy from Rule 32(a)(4), Judge Forrest concluded "that the [witness] fall[s] outside the bankruptcy court's subpoena power because it defines witnesses who are 'more than 100 miles from the place of . . . trial' as 'unavailable.'" She found

> no indication in this rule that the geographical limitation can be recalibrated under Rule 43(a) to the location of a remote witness rather than the location of trial, nor is there any indication that courts can avoid the consequences of a witness's unavailability by ordering remote testimony.

Describing how the two rules work together, Judge Forrest held:

> Rule 43 does not give courts broader *power* to compel remote testimony; it gives courts *discretion* to allow a witness otherwise within the scope of its authority to appear remotely if the requirements of Rule 43(a) are satisfied. [Emphasis in original.]

Next, Judge Forrest said that interpreting the "place of compliance" to be the location of the witness "is contrary to Rule 45(c)'s plain language that trial subpoenas command a witness to 'attend *a trial*.'" [Emphasis in original.] Indeed, if the place of compliance were the location of the witness,

> there would be no reason to consider a long-distance witness "unavailable" or for the rules to provide an alternative means for presenting evidence from long-distance witnesses that are not subject to the court's subpoena power.

Finding that the witness satisfied the third *Bauman* factor, Judge Forrest held "that the bankruptcy court 'misinterpreted the law' in its construction of Rule 45(c) as applied to witnesses allowed to testify remotely under Rule 43(a).

Proceeding to find that the witness had also satisfied the other *Bauman* factors, Judge Forrest issued the writ of mandamus, ordering the bankruptcy court to quash the trial subpoena.

The opinion is *Kirkland v. U.S. Bankruptcy Court (In re Kirkland)*, 22-70092 (9th Cir. July 27, 2023).


# *Plans & Confirmation*


***The Treasury rate and prime rate are both proper starting points for pegging post-petition interest rates, but starting with Treasurys requires a larger risk premium.***

# *Till* Doesn't Require Starting with the Prime Rate, Eighth Circuit Says

In fixing the interest rate to be imposed in a cramdown on a secured creditor, the Eighth Circuit holds that *Till* did not require using the prime rate as the starting point. As long as the risk-adjustment is adequate, the August 2 opinion allows the Treasury bill rate to be the starting point.

A family farmer in chapter 12 proposed a cramdown plan to compensate a secured lender who held a $595,000 mortgage on property worth $1.45 million. The loan had interest rates ranging from 3.5% to 7.6% on various tranches.

The lender and the debtor agreed on a 20-year loan to satisfy the secured claim in the chapter 12 plan. They disagreed about the interest rate.

The debtor proposed a 4% interest rate, derived by adding a 2% risk-adjustment to the 1.87% prime rate at the relevant time. The lender argued for a 5.25% rate, starting with the 3.25% prime rate at the time plus 2% for risk.

Bankruptcy Judge Anita L. Shodeen of Des Moines, Iowa, sided with the debtor and picked 4% as the interest rate on the secured claim under the plan. The lender appealed, but the district court affirmed. The lender appealed to the circuit, contending it was error to begin with the Treasury rate and saying that *Till* required starting with the prime rate. *See Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

The parties agreed on using the so-called formula approach to fix the interest rate. The debtor advocated following *U.S. v. Doud*, 869 F.2d 1144, 1146 (8th Cir. 1989), a chapter 12 case. In his opinion for the appeals court, Circuit Judge Raymond Gruender explained that *Doud* was decided before *Till* and held that it was not clearly erroneous to begin with the Treasury rate and add a relevant risk-adjustment.

In the Supreme Court's later *Till* decision, Judge Gruender said that the plurality "favored the formula approach, which it characterized as requiring a court to begin with the national prime rate and then adjust upward for the typically greater risk of nonpayment." He went on to say:


> *Till* did not explicitly analyze the merits of starting with the prime rate versus the treasury rate. The Court discussed the prime rate simply because that was what the formula-approach proponents used. As for the appropriate risk adjustment on top of the prime rate, the plurality did not decide; it merely observed that courts had generally approved adjustments of 1% to 3%.

*Till, supra*, 541 U.S. at 480.

Judge Gruender disagreed with "the proposition that the prime rate is *the* rate with which to start and that starting with the treasury rate is legal error." [Emphasis in original.] He said that "*Doud* and *Till* are not cases about particular starting rates."

Having found no error in starting with the Treasury rate, Judge Gruender said that "the appropriate risk adjustment depends on the risk already accounted for in the starting rate." He cited a law review article for the proposition that the Treasury rate is risk-free and the prime rate includes a risk premium.

Consequently, Judge Gruender said that "the starting point will influence the risk adjustment" and that the lender's argument "is simply a red herring."

Reviewing for clear error, Judge Gruender found "none." He said that the bankruptcy judge considered the length of the maturity period and the fact that the loan was "substantially over-secured." The 4% rate approved by the bankruptcy court worked out to the 2% Treasury rate plus a 2% risk-adjustment.

Judge Gruender noted that the approved rate "happens to equal" the 3.25% prime rate plus "a modest risk adjustment of 0.75%."

The appeals court affirmed Judge Shodeen's judgment, because "focusing on the starting rate rather than the ultimate rate . . . was sufficient to ensure full payment on 'the value, as of the effective date of the plan,' of the secured claim. *See* § 1225(a)(5)(B)(ii)."

The opinion is *Farm Credit Services of America v. Topp (In re Topp)*, 22-2577 (8th Cir. Aug. 2, 2023).


***The Fourth Circuit wrote a scholarly (and dense) opinion differentiating among bankruptcy standing, bankruptcy appellate standing and constitutional standing.***

# Fourth Circuit Says an Insurer Has No Right to Negotiate an 'Asbestos' Plan

In an appeal dealing with an "insurance neutral" chapter 11 plan resolving asbestos claims, the Fourth Circuit explored the differences among standing in bankruptcy court under Section 1109(b), standing to appeal in bankruptcy cases and constitutional or Article III standing.

The February 14 opinion is perhaps most significant because it holds that an insurer has no right to participate in negotiations dealing with the insurance policy, as long as the plan ends up being "insurance neutral."

The opinion by Circuit Judge G. Steven Agee teaches us that an insurance company found by the bankruptcy court to have no standing does have standing to appeal the denial of standing to object to confirmation of the chapter 11 plan. On the other hand, if the appeals court confirms that the plan is "insurance neutral," then the insurance company has no standing in the bankruptcy court or on appeal to object to the merits of the plan pertaining to any other aspects of the plan.

## The 'Asbestos' Case

Faced with 14,000 pending lawsuits, the corporate debtor proposed a chapter 11 plan under Section 524(g) to create a trust dealing with present and future asbestos claims. All asbestos claims were to be channeled to the trust.

The principal asset for the trust was the debtor's primary insurance policy, with a coverage limit of $500,000 per claim. The insurer was obliged by the policy to defend and indemnify the debtor, even if the claim were false or fraudulent. The policy had no maximum aggregate limit, and it was non-eroding, meaning that defense costs were not counted against the policy limit for each claim.

The plan divided asbestos claims into two classes: (1) those covered by the policy; and (2) those not covered by the policy. Uninsured claims were to be paid entirely by the trust.

Claims covered by insurance were to be litigated in the tort system, nominally against the debtor but subject to the coverage limit for each claim. The trust would pay the $5,000 deductible for each claim.


The claims covered by insurance remained subject to the insurer's prepetition coverage defenses.

The uninsured claims were subject to antifraud provisions under the plan to protect the trust by requiring the claimants to provide disclosures designed to avoid fraud and duplicate claims. The plan had no antifraud provisions for insured claims.

Unsecured creditors were to be paid in full.

The asbestos claimants, the only class impaired by the plan, voted unanimously in favor of the plan. The only confirmation objection came from the insurer.

The insurer contended that the plan was not proposed in good faith and that the plan was not insurance neutral. The bankruptcy court wrote an opinion recommending that the district court approve the plan, finding that it was insurance neutral and filed in good faith. Because the plan was insurance neutral, the bankruptcy court concluded that the insurer was not a party in interest under Section 1109(b) and thus lacked standing to challenge the plan.

The district court confirmed the plan, adopting the bankruptcy court's findings *in toto* after *de novo* review.

The insurer appealed to the circuit.

Bankruptcy Standing

The debtor contended that the insurer had no standing to appeal because the plan was insurance neutral.

In the Fourth Circuit, the concept of bankruptcy appellate standing requires that the appellant be a "person aggrieved" who is directly and adversely affected in a pecuniary sense.

The former Bankruptcy Act had a provision specifically imposing the "person aggrieved" test for appellate standing. The textual limitation was omitted alongside adoption of the Bankruptcy Code in 1978, but Judge Agee noted how circuit courts continued imposing the "person aggrieved" test.

Judge Agee described the differences between standing in bankruptcy court and standing to appeal.


For standing in bankruptcy court, distinguished from standing to appeal, the insurer's standing was governed by Section 1109(b), which confers on "[a] party in interest, including . . . a creditor . . . . ," the right to "appear and be heard on any issue" in the chapter 11 case.

Judge Agee held that the insurer "indisputably [had] standing to appeal the district court's conclusion that it lacked § 1109(b) standing, either as an insurer or as a creditor, to challenge the Plan in the first instance." He pointed to the Third Circuit for having held that standing to appeal the substance of the bankruptcy court's decision is distinct from the right to appeal "bankruptcy standing" under Section 1109(b).

Were a creditor unable to appeal denial of bankruptcy standing under Section 1109(b), Judge Agee again cited the Third Circuit for the proposition that an erroneous finding of a lack of bankruptcy standing would preclude the creditor from appealing the erroneous finding.

In sum, Judge Agee said that the insurer had standing to appeal the district's decision that it did not have bankruptcy standing under Section 1190(b). In a footnote, he also said that the insurer had Article III, or constitutional, standing to challenge the finding of insurance neutrality.

Insurance Neutrality

If the plan was truly insurance neutral, then the insurer would have no bankruptcy standing. Judge Agee reviewed the neutrality findings *de novo*.

Following the Third Circuit, Judge Agee said that a plan is insurance neutral if it does not increase the insurer's prepetition obligations or impair the insurer's prepetition rights under the policy. He found the plan to be neutral, in part because it preserved the insurer's coverage defenses.

The insurer had other arguments. Primarily, the insurer contended that the plan was not insurance neutral because the debtor precluded the insurer from negotiating the plan.

Judge Agee found "nothing in the policy provision [that] suggests that the Debtors' assistance-and-cooperation obligations extend to bankruptcy-plan negotiations." More particularly, he said that the debtor's assistance obligations under the policy involve "traditional litigation activities, as opposed to activities typically undertaken in a bankruptcy proceeding."

The insurer also contended that the plan was not neutral because insured claims were not subjected to the antifraud provisions that applied to uninsured claims. Judge Agee rejected the argument, because "those alleged rights never existed under the policies."

Having found that the plan indeed was insurance neutral, Judge Agee held that the insurer, but only in its capacity as an insurer, did not have bankruptcy standing as a party in interest under Section 1109(b).


Bankruptcy Appellate Standing

The insurer argued that it also had standing on appeal to challenge other provisions of the plan, such as good faith, because it also was a creditor on account of unpaid deductibles. In that respect, Judge Agee said that the insurer, in its capacity as a creditor, was subject to the strictures of Article III standing, also known as constitutional standing. That is to say, was there a case or controversy?

As a creditor, the insurer was unimpaired and had no objections to its treatment as a creditor. Thus, Judge Agee said, the insurer alleged no injury in fact as a creditor. Consequently, the insurer had no Article III standing "to object to aspects of a reorganization plan that in no way relate to its status *as a creditor* but instead implicate only the rights of third parties (who actually *support* the Plan)." [Emphasis in original.]

Judge Agee affirmed the district court's judgment because (1) insurance neutrality left the insurer bereft of bankruptcy standing under Section 1109(b), and (2) the insurer had no Article III standing as a creditor to object to other aspects of the plan.

The opinion is *Truck Insurance Exchange v. Kaiser Gypsum Co. (In re Kaiser Gypsum Co.)*, 21-1858 (4th Cir. Feb. 14, 2023).


***Baltimore district judge applies the Fourth Circuit's 'substantial and unanticipated' test to modifications of chapter 11 plans.***

# Denial of Modification of a Chapter 11 Plan is Final and Appealable

Although the Supreme Court held in *Bullard* that an order denying confirmation of a chapter 13 plan is not a final, appealable order, District Judge Brendan A. Hurson of Baltimore held that denial of a motion to modify a chapter 11 plan is an appealable order. *See Bullard v. Blue Hills Bank*, 575 U.S. 496 (2015).

In his December 19 opinion, Judge Hurson also held that the Fourth Circuit's "substantial and unanticipated" test for modification of a chapter 13 plan applies equally to modification of a chapter 11 plan.

A couple confirmed a plan in 2013 after slogging through chapter 11 for more than two years. They were periodically unemployed but owned a home and eleven rental properties. After confirmation, they soon encountered financial difficulties and fell behind on their plan payments.

In late 2020, the debtors filed a motion to modify and extend their plan. Several creditors objected to the modification. Bankruptcy Judge Thomas J. Catliota sustained the objections and entered an order denying confirmation of the modified plan.

## Finality

On appeal, creditors contended that denial of confirmation of an amended plan was not a final order appealable under 28 U.S.C. § 158(a).

Judge Hurson it "is well accepted that approval of a post-confirmation motion to modify constitutes a final order from which a party may appeal as of right." Citing *Germeraad v. Powers*, 826 F.3d 962, 966 (7th Cir. 2016), he observed that "[s]everal district and circuit courts across the country have found that a denial of a postconfirmation motion to modify also constitutes an appealable final decision." To read ABI's report on *Germeraad*, click here.

On the other hand, Judge Hurson cited the Eighth Circuit Bankruptcy Appellate Panel for holding that denial of a plan modification motion is no more appealable than denial of confirmation. *See In re Vincent*, 301 B.R. 734, 738 (B.A.P. 8th Cir. 2003).


Focusing on the Fourth Circuit, Judge Hurson cited pre-*Bullard* decisions where the Richmond-based appeals court ruled on denials of plan modifications, but without analyzing jurisdiction. He found jurisdiction to entertain the appeal, observing:

> [T]hough there is precedent from at least one other circuit indicating that a denial of a post-confirmation motion to modify does not constitute an appealable order, there is considerably more out-of-circuit caselaw that supports the opposite finding, and Fourth Circuit caselaw suggests that such an order constitutes an appealable final decision in this circuit.

The Test for Plan Modification

The debtors contended on appeal that the bankruptcy court erred by failing to approve the plan modification, thus raising the question of the test to be applied.

To modify plans in chapter 13 cases, Judge Hurson cited the Fourth Circuit for holding that debtors "must first show that they 'experienced a substantial and unanticipated change in [their] post-confirmation financial condition' and then demonstrate that they meet the statutory requirements for such a modification." *In re Murphy*, 474 F.3d 143, 150 (4th Cir. 2007).

Like the bankruptcy court, Judge Hurson held that *Murphy* states the proper test for chapter 11 plan modifications. *Murphy*, he said, is based on the idea that *res judicata* bars plan modifications to provide finality and prevent "parties from seeking to modify plans when minor and anticipated changes in the debtor's financial condition take place." *Id*. at 149.

Judge Hurson applied the *Murphy* test to modifications of chapter 11 plans, saying that it applies "to post-confirmation modifications proposed under § 1329(a) . . . with at least as much vigor to post-confirmation modifications proposed under § 1127(e)."

Applying the *Murphy* test to the appeal, Judge Hurson agreed with the bankruptcy court's conclusion that the changes in the debtors' financial condition were neither substantial nor unanticipated. For example, he said that the debtors were managers of 10 properties and had a "a level of sophistication that should have rendered financial fluctuation anticipated."

Judge Hurson also observed that financial difficulties were not unanticipated because the debtors' income was not sufficient to fund the plan when the plan was first confirmed.

The debtor argued that a $15,000 tax bill was unanticipated. Additional taxes resulted because the debtors were unable to pay mortgages and thus had higher net income. Judge


Hurson said that additional taxes "cannot be said to be unanticipated, as it was a result of Debtors' own failure to meet their mortgage obligations."

Judge Hurson affirmed denial of the motion to modify the plan.

The opinion is *Beard v. Truman 2016 SC MD ML LLC*, 22-2501 (D. Md. Dec. 19, 2023).


# *Stays & Injunctions*


***The concurring opinion, which is really a dissent, urges the Supreme Court to grant certiorari and resolve the split of circuits on nondebtor releases.***

# Second Circuit Reverses, Reinstates Purdue's Nondebtor, Third-Party Releases

Reversing the district court, the Second Circuit reinstated the bankruptcy court's confirmation of the chapter 11 plan of Purdue Pharma LP and its inclusion of nonconsensual releases of creditors' direct claims against nondebtors.

In the majority's 74-page opinion, Circuit Judge Eunice C. Lee found statutory authority for nondebtor, third-party releases in Sections 105(a) and 1123(b)(6) of the Bankruptcy Code and in "this Circuit's caselaw stating that a bankruptcy court has authority to impose such releases."

Circuit Judge Richard C. Wesley wrote a 14-page concurrence that reads like a dissent and urges the Supreme Court to grant *certiorari* to resolve the split of circuits. Judge Wesley concurred in the judgment because he saw the issue as having been resolved in *In re Drexel Burnham Lambert Grp., Inc.*, 960 F.2d 285, 293 (2d Cir. 1992), Second Circuit authority that "has not been overruled either by the Supreme Court or by this Court sitting *en banc*."

The third judge on the panel was Circuit Judge Jon O. Newman. Having served 44 years on the appeals court, he is the most senior judge on the Second Circuit.

The Opioid Claims, the Chapter 11 Case, and Reversal in District Court

Judge Lee devoted 30 pages of her opinion to laying out the facts, the deluge of opioid claims against Purdue and the controlling Sackler family, the chapter 11 case, the confirmation of the plan by now-retired Bankruptcy Judge Robert D. Drain and the reversal of confirmation by District Judge Colleen McMahon of Manhattan.

Foretelling the result, Judge Lee pointed out early in her opinion that the Sacklers were contributing $5.5 billion to $6 billion in return for receiving releases.

To deal with tens of thousands of lawsuits, the company filed a chapter 11 petition in September 2019, but the Sacklers did not file, nor did any company officers or directors. One month after filing, the bankruptcy court imposed an injunction halting all lawsuits against debtors and nondebtors alike.


After bankruptcy, the company resolved a criminal complaint by entering into a plea agreement that called for the company to pay $2 billion, which would come ahead of all creditor claims. However, the agreement would allow the company to pay most of the $2 billion into a trust for the benefit of claimants.

Originally, Purdue's plan had a $4.325 billion contribution to be made by the Sacklers over nine years. In return, the individuals were to receive releases that Judge Lee characterized as "extremely broad." With 95% in favor, she said that creditors "overwhelmingly" approved the plan.

During the course of the confirmation hearing, Bankruptcy Judge Drain required the debtors to narrow the scope of the third-party releases by providing that the debtor's conduct must be the legal cause or a relevant factor in the claims against released individuals.

As revised, Judge Drain confirmed the plan in September 2021 and delivered a lengthy, detailed opinion finding facts and stating the law as he saw it. He noted that while most circuits permit nondebtor releases, the Fifth, Ninth and Tenth Circuits don't.

Bankruptcy Judge Drain said the plan was the only reasonably conceivable means for resolving the case and satisfied the seven requirements demanded by *In re Iridium Operating LLC*, 478 F.3d 452, 464–66 (2d Cir. 2007). As authority for the nonconsensual releases, he found statutory power in Sections 105(a) and 1123(b)(6) and caselaw justification in *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005), and other Second Circuit authority.

The U.S. Trustee and several states appealed. District Judge McMahon set aside confirmation by reversing in December 2021. *In re Purdue Pharma, L.P.*, 635 14 B.R. 26 (S.D.N.Y. 2021). She found no statutory authority for the third-party releases. According to Judge Lee, the district judge "ejected the argument that the bankruptcy court possessed residual equitable authority to impose the Releases." To read ABI's report on the district court reversal, click here.

The Appeal to the Circuit

The company, the official creditors' committee, the Sacklers and others appealed. The appeals court heard oral argument on April 29, 2022.

While the appeal was pending, nine states dropped their opposition to the plan when the Sacklers agreed to contribute an additional $1.175 billion to $1.675 billion, raising their total payments to as much as $6 billion.

The U.S. Trustee was the remaining appellee, along with Canadian municipalities and indigenous tribes from Canada.


Addressing the merits, Judge Lee agreed with District Judge McMahon on one point: The bankruptcy court lacked constitutional power to enter a final judgment containing the third-party releases because they are the types of claims proscribed in *Stern v. Marshall*. In other words, the bankruptcy court could only issue proposed findings and conclusions for entry by the district court.

Judge Lee went on to say:

> [W]e agree with the district court that the practical import of the *Stern* issue is nonexistent given that only conclusions of law are at issue here, requiring our *de novo* review under any standard.

[Note: This writer respectfully disagrees. It's not nothing. If the bankruptcy court may only enter proposed findings and conclusions in similar circumstances, a chapter 11 plan may not be confirmed and consummated until the equivalent of an appeal has been completed in district court.]

Question One

Judge Lee tackled the first of two pivotal questions: "[W]hether the bankruptcy court had the authority to approve the nonconsensual release of direct third-party claims against the Sacklers, a non-debtor."

Judge Lee divided the releases into two categories: direct claims and derivative claims. Citing *Marshall v. Picard (In re Bernard L. Madoff Inv. Secs. LLC)*, 740 F.3d 81, 89 n.9 (2d Cir. 2014), she said it was "well settled" that the bankruptcy court may release derivative claims, which are those that arise from harm to the estate.

On the other hand, Judge Lee defined "direct claims [as] causes of action brought to redress a direct harm to a plaintiff caused by a non-debtor third party." Citing *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 91 (2d Cir. 1988), she said that a release of those claims would not be a discharge prohibited by Section 524(e), "because the releases neither offer umbrella protection against liability nor extinguish all claims."

Next, Judge Lee agreed "with both the bankruptcy court and the district court that the bankruptcy court had statutory jurisdiction to impose the Releases because it is conceivable, indeed likely, that the resolution of the released claims would directly impact [the estate]."

Statutory Authority

Judge Lee said that the bankruptcy court "correctly grounded its authority for approving the Releases in §§ 105(a) and 1123(b)(6)." Section 105(a) allows a bankruptcy court to issue "any order" that is "necessary or appropriate to carry out the provisions of" the Bankruptcy Code.


Section 1123(b)(6) permits a chapter 11 plan to "include any other appropriate provision not inconsistent with the applicable provisions of this title."

Judge Lee rejected the debtor's contention that Section 105(a) alone was up to the task. However, the combination of Section 105(a) with Section 1123(b)(6) made the magic elixir. She said that "§ 1123(b)(6) is limited only by what the Code expressly forbids, not what the Code explicitly allows." She cited the Seventh Circuit for having "convincingly" held that the section includes the power to release third parties.

If there were any doubt before, Judge Lee said, "we now explicitly agree with [the Sixth and Seventh Circuits] and conclude that § 1123(b)(6), with § 105(a), permit bankruptcy courts' imposition of third-party releases."

Second Circuit Caselaw

Having found statutory power, Judge Lee said that "this Court's precedents permit the imposition of nonconsensual third-party releases." She said that *Manville* and *Metromedia* "further confirm that such releases are neither discharges nor allowable only in the context of asbestos cases."

"More importantly," Judge Lee said, "this Court's opinion in *Metromedia* flatly rejects a restrictive interpretation of the Bankruptcy Code by stating that third-party releases can be valid outside of the asbestos context." She added, though, that "*Metromedia* nevertheless rests upon the premise that such releases may be permitted so long as bankruptcy courts make sufficient factual findings and satisfy certain equitable considerations."

Having found jurisdiction along with statutory and caselaw authority, Judge Lee analyzed the bankruptcy court's findings of fact and concluded that they satisfied the seven-part test imposed by *Metromedia*. Among other factors, the releases were necessary; the nondebtors made substantial contributions, and the affected creditors voted "overwhelmingly" in favor of the plan. She pointed to Section 524(g)(2)(B)(ii)(IV)(bb) for the concept that a 75% vote is the minimum.

Before ending her opinion, Judge Lee rejected the U.S. Trustee's argument that due process required that creditors be allowed to opt out.

Judge Lee reversed the district court, affirmed the bankruptcy court's approval of the plan and remanded for proceedings consistent with the opinion.

The Concurrence by Judge Wesley


Judge Wesley concurred in the judgment, because he read *Drexel* to mean that bankruptcy courts "have the power to release direct or particularized claims asserted by third parties against nondebtors without the third parties' consent."

Because *Drexel* had not been overruled by the Supreme Court or the Second Circuit sitting *en banc*, Judge Wesley said he "reluctantly" concurred. He said that neither *Drexel* nor *Metromedia* "tracks that power back to any provision of the Bankruptcy Code." Likewise, he saw nothing in Sections 105(a) or 1123(b)(6) about nondebtor releases. Indeed, he said that the Bankruptcy Code "is silent on the matter."

To buttress his views, Judge Wesley noted that claims for fraud cannot be discharged in bankruptcy but that the third-party releases had no carveouts for fraud. In other words, the releases, he said, were "broader than that which Congress decided was wise to make available to a debtor in bankruptcy."

Further, Judge Wesley said that creditors with direct claims receive nothing extra for those claims. Their recovery, he said, is identical to the recovery by a similar creditor with no direct claims against third parties.

"At bottom," Judge Wesley said, "if Congress intended so extraordinary a grant of authority, it should say so," like it did in 1994 when amending the Code to allow nondebtor releases in asbestos cases.

Given that nondebtor releases are "an extraordinarily powerful tool," Judge Wesley said that the question "would benefit from nationwide resolution by the Supreme Court" of "a weighty issue that, for too long, has split the courts of appeals."

The opinion is *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 22-110 (2d Cir. May 30, 2023).


***The Fifth Circuit dissenter says that the majority set aside findings of fact without showing them to be clearly erroneous.***

# Fifth Circuit Vacates $240,000 in Sanctions for Being Criminal, Not Civil, Contempt

Over dissent, the Fifth Circuit vacated $240,000 in sanctions, holding that the award was damages for criminal contempt which the bankruptcy court had no power to impose.

The appeal arose from the chapter 11 liquidation in Dallas of Highland Capital Management. In his April 4 opinion for the majority, Circuit Judge Andrew S. Oldham said that the "case has been full of" what he called "vexatious litigation."

The Aborted Lawsuit

Like much of the litigation arising throughout the case, the controversy traced its roots to a stipulation with the creditors' committee where the debtor's chief executive gave up control. A chief restructuring officer took over.

To protect the CRO, Judge Oldham described how the bankruptcy court entered a "gatekeeping order" that prohibited anyone from suing the CRO without authorization from the bankruptcy court based on a "colorable claim" for willful misconduct or gross negligence. The order went on to say that the bankruptcy court "shall have sole jurisdiction to adjudicate any such claim for which approval of the Court to commence or pursue has been granted."

Notwithstanding the gatekeeping order, two entities affiliated with the former CEO sued the debtor in federal district court, alleging that the debtor, through the CRO, engaged in self-dealing in connection with a settlement that had been approved by the bankruptcy court.

One week later, the plaintiffs filed a motion to amend the complaint to add the CRO as a defendant. The former CEO's affiliates didn't have the bankruptcy court's approval to sue the CRO, but the plaintiffs reasoned that suing in the supervising district court "obviated this defect," Judge Oldham said.

On procedural grounds, the district court dismissed the motion one day after it was filed.

After dismissal, the bankruptcy court granted the debtor's motion for the former CEO's affiliates and their counsel to show cause why they should not be held in contempt for violating the gatekeeping order.


After what Judge Oldman called "extensive discovery" and a "lengthy evidentiary hearing," the bankruptcy court held the former CEO, his affiliates and their counsel in contempt and directed them to pay the debtor about $240,000.

The CEO, his affiliates and their counsel appealed, contending that the sanctions were criminal and beyond the power of the bankruptcy court. The district court affirmed, prompting an appeal to the Fifth Circuit.

The Majority Opinion

Judge Oldham began his opinion for the majority by reciting that bankruptcy courts are not Article III courts and lack inherent power to punish violations of their orders with criminal contempt. They "have only civil contempt powers because that is all Congress has given them," he said.

Judge Oldham went on to say that the "civil contempt power is limited" and may not have a "primary purpose" of punishing or vindicating the authority of the court. Instead, he said that use of the civil contempt power must be "remedial" by coercing compliance or compensating the injured party for its actual loss.

Quoting the Supreme Court, Judge Oldham said that "a bankruptcy court may shift 'only those attorney's fees incurred because of the misconduct at issue.'" *Goodyear Tire & Rubber Co. v. Haeger*, 581 U.S. 101, 109 (2017).

Judge Oldham said that the only contumacious conduct was filing the motion in district court to add the CRO as a defendant. He said that the bankruptcy court and district court both "reasoned that the award was compensatory because it shifted expenses [that the debtor] reasonably and necessarily incurred in responding to the Motion [to add the CRO as a defendant]."

"Both courts were wrong," Judge Oldham said. He saw the debtor as having "incurred virtually all its contempt-related expenses because the bankruptcy court permitted extensive discovery and conducted a marathon evidentiary hearing to unearth [the former CEO's] role in filing the Motion [to add the CRO as a defendant]." He added that the former CEO's intentions "were irrelevant to *civil* contempt." [Emphasis in original.]

As Judge Oldham saw it, "The only question in civil contempt is whether and to what extent [the debtor] was damaged by [the former CEO's affiliates'] choice to file the Motion in the wrong forum."

Judge Oldham vacated the district court's judgment and remanded with instructions


> to limit any sanction award to the damages [the debtor] suffered because [the former CEO's affiliates] filed the Motion in the wrong court—*i.e.*, the expenses [the debtor] reasonably incurred in opposing the Motion in district court [to add the CRO as a defendant], less those it would have spent opposing the Motion had it been filed in bankruptcy court.

The Dissent

Circuit Judge James L. Dennis dissented, saying that he "sincerely disagree[s] with the majority" and "would affirm the bankruptcy court's" award of $240,000 in "civil compensatory" sanctions.

Judge Dennis said that "the panel majority disregards the three applicable standards of review." He said that "the majority selectively picks mere seconds of [the debtor's] counsel's oral argument as constituting an agreement that [the former CEO's affiliates'] '*only* contumacious conduct' was filing their motion in the wrong court, suggesting that the misfiling was a mere inadvertence." [Emphasis in original.]

Judge Dennis said that the "record contains no facts or evidence indicating that [the debtor's] counsel agreed to such an incorrect and rhetorically disadvantageous position." He concluded that "the bankruptcy court and the district court committed no error of law, no clear error of fact, and no abuse of discretion."

"I respectfully dissent from the majority's reversal of the bankruptcy and district courts' judgments," Judge Dennis said.

The opinions are in *Charitable DAF Fund LP v. Highland Capital Management LP (In re Highland Capital Management LP)*, 22-11306 (5th Cir. April 4, 2024).


***When the debtor files bankruptcy before the time has elapsed for a creditor to file a cross appeal, the cross appeal is deemed timely when filed within 30 days after the stay terminated, the Tenth Circuit held.***

## A Bankruptcy Petition Automatically Stays the Filing of an Appeal or a Cross Appeal

The filing of a bankruptcy petition tolls the time for both the debtor and a creditor to file a notice of appeal or a cross appeal in a suit that was pending at the time of filing, according to the Tenth Circuit.

A manufacturer of nutritional supplements sued a competitor for false advertising in violation of the Lanham Act and similar Utah state law. After a bench trial, the district court found violations of state and federal law and entered a $9.5 million judgment in favor of the plaintiff, plus attorneys' fees for discovery violations.

The district court denied the plaintiff's request for punitive damages and an injunction.

The defendant filed a notice of appeal, followed a few days later by a chapter 11 petition. After the automatic stay was dissolved, the plaintiff quicky filed a cross appeal.

The plaintiff had filed its cross appeal more than one year after the debtor had filed the initial appeal. Under F.R.A.P. 4(a)(3), the plaintiff's cross appeal was due within 14 days after the defendant had appealed. Was the cross appeal timely? Did the appeals court have jurisdiction with regard to the cross appeal?

The plaintiff argued that the automatic stay in Section 362(a) precluded the filing of a cross appeal until the stay terminated.

Tenth Circuit Judge David M. Ebel first quoted Section 362(a)(1), which says that the filing of the petition "operates as a stay" of "the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case . . . ."

"If there is a pending non-bankruptcy deadline when the stay takes effect," Judge Ebel said, "this deadline is tolled until the later of either 'the end of such period' or '30 days after notice of the termination or expiration of the stay,'" citing Section 108(c)(1)(2).


Judge Ebel was persuaded by the Eighth Circuit, which, he said, had held that "'an appeal . . . in a case in which the debtor originally was the defendant is a "continuation" of a "proceeding against the debtor'" such that § 108(c) tolls the deadline of an appeal against a debtor." *In re Hoffingers Inds., Inc.*, 329 F.3d 948, 952 (8th Cir. 2003).

"This makes sense," Judge Ebel said, citing the *Norton* treatise.

"This core purpose would plainly be frustrated if a creditor could engage a debtor on appeal during the stay period," Judge Ebel said. He went on to observe that "this conclusion accords with our precedent, as we have held that the automatic stay bars even a debtor in bankruptcy from appealing an adverse judgment."

"If a *debtor* cannot appeal an adverse judgment during the bankruptcy stay, then surely a *creditor* is not permitted to file an appeal when a stay is in place," Judge Ebel said. [Emphasis in original.]

Judge Ebel held "that filing a cross-appeal constitutes the 'commencement or continuation' of a judicial action or proceeding, and so the deadline to file a cross-appeal is tolled by § 108(c)(2) during a bankruptcy proceeding of the cross-appellee." Because the plaintiff had cross appealed fewer than 30 days after the stay terminated, he held that the cross appeal was timely.

The appeals court upheld the judgment of liability under federal and state law together with the assessment of attorneys' fees. The circuit further ruled in favor of the plaintiff by remanding for the district court to decide whether the plaintiff was entitled to punitive damages and an injunction.

The opinion is *Heartwise Inc. v. Vitamins Online Inc.*, 20-4126 (10th Cir. June 27, 2023).


***Bankruptcy Judge Russin declines to follow the Third Circuit and adopts the conclusion of bankruptcy courts holding that Sub S status is estate property.***

# Debtor's Subchapter S Status Is Estate Property that an Owner Can't Terminate

Deciding that the "syllogistic reasoning" of the Third Circuit was "faulty," Bankruptcy Judge Peter D. Russin of Fort Lauderdale, Fla., instead followed several lower courts and held that a debtor's status as a Subchapter S corporation is estate property that the owner cannot terminate in view of the automatic stay.

Even if the owner were entitled to a stay modification, Judge Russin also ruled in his October 6 opinion that the power to terminate a Subchapter S election rests in the corporation, not in the owner.

The Sale and the Resulting Tax Liability

The debtor was a corporation that elected Subchapter S status at inception in 1993. In the ensuing years, Judge Russin said that the debtor corporation "has avoided tax liability by passing its income, losses, deductions, and credits to [the owner, who] has been able to avoid double taxation on all distributions from [the debtor] for the past three decades, just as contemplated by the creators of the S corporation."

Saddled with "significant judgments" in 2022, the debtor filed a chapter 11 petition the following month. The owner had been the sole officer and director. Replaced by a restructuring officer, the owner was removed as an officer and director after the appointment of an independent board during the chapter 11 case.

The debtor contracted to sell the assets for $370 million. Closing the sale, according to Judge Russin, would generate only $11.6 million for unsecured creditors, after dealing with secured lenders.

As Judge Russin said, "all the taxable income from the sale would flow through to [the owner], making him liable for the resulting taxes." Consequently, the owner filed a motion for a declaration that Subchapter S status was not estate property, thus allowing him to revoke Subchapter S status in the absence of the automatic stay. Alternatively, the owner wanted Judge Russin to modify the stay.


If the Subchapter S election were revoked, the experts disagreed about the resulting tax liabilities. In the worst case, the debtor would have a $27.5 million tax liability, eliminating the distribution to unsecured creditors and rendering the estate administratively insolvent.

In the best case scenario for the debtor, the tax bill would be $9.2 million, reducing the distribution to unsecured creditors by 80%.

The experts also disagreed about the tax effects for the owner if the Sub S status were to remain. Judge Russin found the debtor's expert to be more credible and deduced that the owner would have a $3.4 million tax bill. The debtor's expert predicted tax liability to be between $95 million and $197 million.

Aside from the $3.4 million tax liability, Judge Russin found that the owner could carry forward $49 million in net capital losses and $23 million in net operating losses.

Estate Property or Not?

To decide whether Sub S status is or is not estate property, Judge Russin began with Section 541(a), which says that estate property is comprised of, among other things, "all legal or equitable interests of the debtor in property as of the commencement of the case." He quoted the *Collier* treatise for saying that "anything not specifically excluded under [§ 541(b)] should be included as property of the estate."

For authority, Judge Russin relied primarily on *Segal v. Rochelle*, 382 U.S. 375, 381 (1966), where the Supreme Court held that net operating loss carrybacks were property of the estate under Section 70(a)(5) of the former Bankruptcy Act. The Court did not consider whether loss carryforwards are estate property, Judge Russin said.

However, Judge Russin cited the Second Circuit for holding in 1991 that NOL carryforwards are also estate property.

On point, Judge Russin cited a "number of bankruptcy courts [that] have held that an S election is also property of the estate."

Countering bankruptcy court decisions, the owner cited *Majestic Star Casino, LLC v. Barden Dev., Inc. (In re The Majestic Star Casino, LLC)*, 716 F.3d 736 (3d Cir. 2013), where the Third Circuit held that Sub S status is not "property." Judge Russin found *Majestic Star*'s "syllogistic reasoning" to be "faulty."

Judge Russin found other faults in the Third Circuit's analysis as well. While owners can take action that will result in the termination of a Sub S election by selling the shares to a


foreigner, for example, he said "it is only the corporation that can revoke its S election, though it cannot do so without the consent of the majority of shareholders."

For Judge Russin, whether an owner could unilaterally act to end Sub S status was "irrelevant," because property interests in Section 541 are not limited "to property interests that are noncontingent."

Judge Russin saw a "valued right" for the corporation in not having to pay taxes and saw "no basis" for believing that the right to avoid taxes "is any less a property right than property that produces income."

Holding that Sub S status is property of the estate, Judge Russin ended where he began, with the broad definition of estate property in Section 541 and the Supreme Court's statement in *Segal* that "the term 'property' has been construed most generously."

No Stay Modification

Alternatively, the debtor wanted Judge Russin to modify the automatic stay so he could revoke Sub S status. The judge found no "cause" to lift the stay.

Judge Russin ran the numbers and concluded that the best outcome would be an 80% loss of the distribution to unsecured creditors resulting from tax liability thrust in the debtor. The worst case was a wipeout for unsecured creditors and administrative insolvency.

Judge Russin concluded that "the harm to [the owner] from the $3.4 million tax liability is far outweighed by the harm that would be caused by granting stay relief so he could avoid it." Furthermore, he said that the "harm is mitigated by the fact that [the owner] will also receive significant tax benefits." The operating and capital loss carryforwards, he said, "could yield $19 million in tax benefits in future years."

Judge Russin said it is "fundamental" that the rights of shareholders in an insolvent corporation "are subordinate" to the rights of creditors. He found no cause to modify the stay, because doing so would "run afoul" of this "fundamental principle" if avoiding a $3.4 million tax liability was at the expense of unsecured creditors.

Even if there were cause to lift the stay, Judge Russin said that modifying the stay would be "futile."

Judge Russin cited the IRS Code and Regulations in concluding that the owner "cannot force [the debtor] to revoke its S election" and said that he "would certainly not order the officers and directors of [the debtor] to breach their fiduciary duties by doing so."


Judge Russin closed his opinion by saying that Sub S status is estate property protected by the automatic stay. He saw no "cause" to lift the stay, "because the harm from lifting the stay far outweighs the harm in keeping it in place." If there were cause, he said, "it would be inappropriate to grant stay relief when stay relief would be futile."

The opinion is *In re Vita Pharmaceuticals*, 22-17842 (Bankr. S.D. Fla. Oct. 6, 2023).


# *Retention & Compensation*


***Although examiners must be appointed on motion, the Third Circuit says that the bankruptcy court retains 'broad discretion' to fix the scope and cost of the investigation.***

# Third Circuit Says: Bankruptcy Courts Have No Discretion to Deny Examiner Motions

Reversing the bankruptcy court in Delaware, the Third Circuit ruled that appointment of an examiner is mandatory in the reorganization of FTX Trading Ltd.

While the Philadelphia-based appeals court held that the bankruptcy court has no discretion to deny appointment of an examiner when someone has filed a motion and the debt is more than $5 million, the Third Circuit noted how the bankruptcy court does have "broad discretion" in defining the "scope, degree, duration, and cost" of the investigation.

In his January 19 opinion, Circuit Judge L. Felipe Restrepo observed that FTX "suffered a catastrophic decline in value" when "industry reports" suggested that the company was "financially compromised" by "multiple corporate failures," including software that concealed "the funneling of FTX customer funds into [affiliate] Alameda Research." In "a few days," he said, customers withdrew "billions of dollars."

Afterwards, Judge Restrepo said that "criminal investigations into FTX have unearthed evidence of widespread fraud and the embezzlement of customers' funds." He noted that FTX's chief executive Sam Bankman-Fried has been convicted on seven criminal counts, including wire fraud.

Denial of the Examiner Motion

Judge Restrepo noted that Bankman-Fried resigned but appointed John J. Ray, III, as chief executive and that Ray has conducted a wide-ranging investigation after putting FTX and affiliates into chapter 11. However, the U.S. Trustee filed a motion for appointment of an examiner under Section 1104(c) "within weeks of the filing."

The U.S. Trustee reasoned that Ray could focus on stabilizing the business while an examiner would investigate the loss of $10 billion in customers' assets. The debtor and the official creditors' committee opposed appointment of an examiner.


The motion turned on the interpretation of Section 1104(c). On "request of a party in interest or the United States trustee" if no chapter 11 trustee has been appointed, the subsection says that "the court *shall* order the appointment of an examiner to conduct such an investigation of the debtor *as is appropriate*," if "the debtor's fixed, liquidated, unsecured debts . . . exceed $5,000,000." [Emphasis added.]

Judge Restrepo characterized the bankruptcy judge as having reasoned that the words "as is appropriate" gave the court discretion to appoint an examiner despite the statute's use of the word "shall." For reasons given from the bench, the bankruptcy judge denied the motion for an examiner. The U.S. Trustee appealed, and the Third Circuit accepted a direct appeal.

Does 'Shall' Mean 'May'?

Judge Restrepo stated the question on appeal as "whether the plain text of Section 1104(c)(2) requires a bankruptcy court to appoint an examiner" when there is a motion and the debt exceeds $5 million.

Quickly, Judge Restrepo noted how "Congress made plain its intention to mandate the appointment of an examiner by using the word 'shall.'" Interpreting "shall" to mean "may," he said, "would require us 'to abandon plain meanings altogether,'" quoting Third Circuit authority.

To the contrary, the debtor argued that "as is appropriate" modifies "shall," to make the outcome discretionary. Judge Restrepo rejected the argument, based on the last-antecedent rule of statutory construction. The rule, he said means that "as is appropriate" modifies "to conduct such an examination."

Judge Restrepo said that appointing an examiner is not unconstrained. There must be a motion, and debt must exceed $5 million. He noted the U.S. Trustee's comment that the government had sought examiners only 10 times nationwide in a recent fiscal year.

While appointment may be mandatory, Judge Restrepo said that "the phrase 'as is appropriate' in Section 1104(c) means the court 'retains broad discretion to direct the examiner's investigation,' including its scope, degree, duration, and cost," quoting the *Norton* treatise.

On appeal, the debtor and the committee argued that having an examiner would be duplicative and wasteful given their own investigations. Judge Restrepo responded, saying, "Neither position is relevant, given our holding that the appointment of the examiner is mandatory under the Code."

Judge Restrepo reversed and remanded with instructions to appoint an examiner.

The opinion is *In re FTX Trading Ltd.*, 23-2297 (3d Cir. Jan. 19, 2024).


***'National' rates higher than 'local' rates can be locked in by retention orders under Section 328(a).***

# U.S. Trustee Rebuffed in Objecting to Rates Higher than Local Rates

In this column in March 2018, we said:

> In years past, a debate raged over "local vs. national rates." The controversy subsided, because courts outside of New York and Delaware generally began allowing compensation to counsel at the rates ubiquitous in their home districts, even when the rates were higher than those prevailing in the venue where the case was located.
>
> The debate also subsided because so many reorganizations are filed in Delaware or New York, where there is no observable cap on hourly rates.

Bankruptcy Judge Selene D. Maddox of Aberdeen, Miss., stifled a reinvigoration of the "local vs. national" debate in an opinion on December 21. In addition, she rejected the idea that compensation for all chapter 11 cases in her district was frozen at rates set by another bankruptcy judge in 2015.

For lawyers from out of town whose rates are higher than prevailing rates in the district where a case is pending, the 52-page opinion by Judge Maddox contains a helpful hint: Lock in your rates with a retention order approving higher rates under Section 328(a).

To read ABI reports about "local vs. national rates," click here, here and here.

Out-of-Town Debtor's Counsel

The corporate debtor was a furniture manufacturer. For its primary bankruptcy advisors, the debtor selected its long-time outside counsel, a Philadelphia-based firm with 825 lawyers spread across 27 offices in the U.S. For local counsel, the debtor tapped a Houston-based firm with 325 lawyers in nine U.S. offices.

In their retention affidavits, both firms said that the debtor had agreed to pay their normal rates. For primary counsel, hourly rates for partners were shown be $640 to $940 an hour. Local counsel's lead partner would charge $650 per hour. There were no objections to the retention applications.


The retention orders authorized the debtor to retain the firms under Sections 327(a) and 328(a). The retention orders did not explicitly approve the hourly rates contained in the retention affidavits. The retention orders did say that compensation was approved as set forth in the retention applications.

On the first interim fee application, general bankruptcy counsel sought less than $110,000 in fees, while local counsel's request was for about $30,000.

The U.S. Trustee objected, mainly because the hourly rates were higher than those for Mississippi counsel. The U.S. Trustee in substance wanted the court to impose what might be understood as a $425 hourly cap espoused in 2015 by another bankruptcy judge in the district in *In re Sanderson Plumbing Prods., Inc.*, 13-14506, 2015 BL 345100 (Bankr. N.D. Miss. Oct. 20, 2015).

The U.S. Trustee said that the case was not complex and that fees should not be so high. The U.S. Trustee also claimed there were duplications of services because local counsel had appeared at hearings alongside primary counsel.

The Significance of Section 328(a) Retention

Both firms countered the objections by asserting that the court had preapproved their rates under Section 328(a). The section allows a debtor or trustee to engage a professional "on any reasonable terms and conditions of employment, including on a retainer, *on an hourly basis*, on a fixed or percentage fee basis, or on a contingent fee basis." [Emphasis added.]

When allowing compensation for retentions approved under Section 328(a), the court may depart from the approved terms of engagement "if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions."

Approval of compensation is different for a professional person retained under Sections 327 or 1103. Section 330(a) permits a court to grant "reasonable compensation for actual, necessary services rendered."

Judge Maddox said that professionals have the option of having their retentions approved under either Section 330(a) or Section 328(a). She began her analysis by deciding whether the retention orders had approved hourly rates under Section 328(a).

Citing the Fifth Circuit, Judge Maddox explained that "Section 328(a) applies when the court approves a fee as part of the employment application at the outset of the engagement, while § 330(a) applies when the court has yet to do so."


If retention was under Section 328(a), Judge Maddox said it's a "high hurdle" to revise the terms of compensation. However, she said that the Fifth Circuit had not clarified "how a court determines whether an applicant's hourly rate or contingency fee has been preapproved under § 328." There are "competing tests" in other circuits "governing preapproval," she said.

The Test for Section 328(a) Retention

Judge Maddox said that the Third and Ninth Circuits require that retention orders must have specifically approved hourly rates. The Second and Sixth Circuits, she said, take "a more relaxed approach" by employing "the totality of the circumstances" to decide whether compensation has been approved under Section 328(a).

For herself, Judge Maddox adopted "a totality of the circumstances test . . . to determine whether an applicant's fee arrangement was preapproved under § 328."

Applying the test, Judge Maddox noted that the retention orders "explicitly" approved employment under Section 328 and that there was sufficient information regarding the firms' hourly rates.

After considering the "totality of the circumstances," Judge Maddox concluded that she had approved hourly rates under Section 328. The "thoroughness" of the retention applications, she said, gave "more than sufficient information to put all parties on notice of the agreement between [the debtor] and the Applicants concerning their agreed upon hourly rates."

Judge Maddox then turned to the question of whether the rates should be reduced as "improvident." She noted how the U.S. Trustee had not claimed that the terms of engagement were improvident. Rather, the U.S. Trustee contended that the case was not sufficiently complex to justify counsel's higher rates.

A case that's not so complex does not "meet the improvident standard," Judge Maddox said. In those circumstances, she said that "a professional whose compensation has been fixed under § 328 should have their expectations protected."

Duplication of Services

The U.S. Trustee claimed there were duplications of services because local counsel attended hearings alongside general bankruptcy counsel. Judge Maddox countered by quoting a local rule that requires local counsel to "participate in all trials . . . and other proceedings conducted in open court."


Judge Maddox overruled the duplication objection, saying that local counsel's "attendance at these hearings was neither unnecessary nor duplicative."

*Sanderson Plumbing*

Although she had decided that fees could not be reduced under Section 328(a), Judge Maddox said she was

> concerned by the UST's reliance on *Sanderson Plumbing* and § 330 not only in this bankruptcy case where § 328 is applicable, but also in other cases where a professional's hourly rate would be subject to review at the compensation stage under § 330's reasonableness factors and the *Johnson* factors.

Judge Maddox went on to say that she "continues" to see the U.S. Trustee invoking *Sanderson Plumbing* whenever hourly rates are more than $425 to $450 per hour. However, she noted that "the prevailing hourly rate in *Sanderson Plumbing* was only applicable under the facts as known to the court in that bankruptcy case at that time." She said it was "not proper to simply point to that case in an objection to an applicant's fees."

"In other words," Judge Maddox said,

> a fee award in other cases is just one of the many factors this Court utilizes in a § 330 analysis, and it certainly should not be the only metric the UST uses in responding or objecting to fee applications.

Next, Judge Maddox analyzed the fee requests under the so-called *Johnson* factors, noting the U.S. Trustee's objection that the requested rates were higher than what firms charge in Mississippi.

If the rates of $425 to $450 per hour as allowed in *Sanderson Plumbing* were adjusted for inflation, Judge Maddox said that range today would be $567 to $640 an hour.

Although there was no evidence that the debtor could not have obtained lead counsel from Mississippi, Judge Maddox agreed "that debtors should be able to choose their own representation." Still, she said that "the appropriate prevailing rates in this community would be in the range of $550.00 to $600.00 per hour for partners or counsel and $350.00 to $400.00 per hour for associates."

If prevailing local rates were applied to the fee applications, Judge Maddox said that counsel would have been granted allowances lower than they requested. Because there were no grounds under Section 328(a) for reducing hourly rates, Judge Maddox said she would not lower the awards.


Using "hindsight," Judge Maddox said, is "a tool not available when hourly rates are preapproved under § 328."

Judge Maddox allowed the fees as requested but required counsel to apply their remaining retainers to the awards before receiving compensation from the debtor.

The opinion is *In re Feilitech LLC*, 23-10599 (Bankr. N.D. Miss. Dec. 21, 2023).


# *Preferences, Fraudulent Transfers & Claims*


***The Seventh Circuit adopted a broad reading of the Section 546(e) safe harbor to dismiss a fraudulent transfer suit attacking a sale of nonpublic securities.***

# Seventh Circuit: Transfers of Nonpublic Securities Are Protected by the 546(e) Safe Harbor

Upholding reversal in district court, the Seventh Circuit declined an invitation to adopt a narrow reading of the Section 546(e) safe harbor in a case involving the purchase of nonpublic securities.

In *Merit Management Group LP v. FTI Consulting Inc.*, 583 U.S. 366, 378 (Feb. 27, 2018), the Supreme Court held that the safe harbor only applies to "the overarching transfer that the trustee seeks to avoid." The March 15 opinion by Seventh Circuit Judge Amy J. St. Eve is in accord with *Merit Management* because the trustee was attempting to avoid a transfer involving a financial institution. The financial institution was not a "mere conduit." To read ABI's report on *Merit Management*, click here.

The opinion is significant because the Seventh Circuit held that the Section 546(e) safe harbor applies to transactions "in connection with" transfers of privately held securities, not only publicly traded securities.

The Leveraged Buyout

The debtor was a company was owned by an employee stock ownership plan trust. A private equity investor purchased the debtor by acquiring the stock from the ESOP. The stock owned by the ESOP was not traded publicly.

The buyer financed the purchase with a $24.9 million bridge loan from a bank. As the target of the acquisition, the debtor was not obligated to the bank, but the buyer was. One month after closing, the debtor obtained loans from a different bank and paid off the $24.9 million bridge loan for which the buyer had been liable on a guarantee, but the debtor was not.

The debtor had pledged its assets as security for the new loans that paid off the $24.9 million bridge loan.

The debtor's business failed more than two years after closing. Creditors filed an involuntary petition, leading to an order for relief and appointment of a chapter 7 trustee.


The payoff of the original bridge loan having occurred more than two years before bankruptcy, the chapter 7 trustee invoked Section 544(b) to step into the shoes of an actual creditor and sue the buyer and the bridge lender for a constructive fraudulent transfer under Indiana law. The trustee alleged that the transfer paying off the bridge loan was "to or for the benefit" of the buyer and that the debtor received no consideration for encumbering its property.

Narrowly reading Section 546(e), the bankruptcy court denied a motion to dismiss based on the safe harbor. *Petr v. BMO Harris Bank N.A. (In re BWGS LLC)*, 643 B.R. 576 (Bankr. S.D. Ind. Aug. 18, 2022). To read ABI's report, click here. The district court authorized an interlocutory appeal. Reading the safe harbor broadly, the district court reversed, ordering dismissal of the suit. *Petr v. BMO Harris Bank N.A.*, 21-50007, 2023 BL 148417, 2023 WL 3203113 (S.D. Ind. May 2, 2023). To read ABI's report, click here.

The trustee appealed to the circuit, to no avail.

'In Connection with' Securities Contracts

The new loan had paid off a financial institution whose loan was used to purchase stock from an ESOP. Applicability of the safe harbor depended on the definition of the term "securities contract" and the interpretation of Section 546(e), which reads:

> the trustee may not avoid a transfer . . . made by or to (or for the benefit of) a . . . financial institution . . . or that is a transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract, as defined in section 741(7), . . . except under section 548(a)(1)(A) of this title [for a transfer made with actual intent to hinder, delay or defraud].

Addressing the merits, Judge St. Eve began by saying that the Seventh Circuit had "never come close" to holding that the safe harbor applies only to transactions involving publicly traded securities. She found "nothing in the plain language of § 546(e) [that] excludes private contracts not implicating the national securities clearance system from the definition of 'securities contract.'"

Looking at the definition of "securities contract" in Section 741(7), Judge St. Eve said that "not one of these eleven sub-definitions contains any indication that it is limited to contracts implicating only publicly held securities." She pointed to the Third, Fifth and Eighth Circuits for having held that "securities contracts" is not limited to publicly held securities.

Judge St. Eve held "that the term 'securities contract' as used in § 546(e) unambiguously includes contracts involving privately held securities." She then had "little trouble" in finding that the purchase agreement, the bridge loan and the purchaser's guarantee were "in connection with" "securities contracts," bringing them all within the ambit of the safe harbor.


To avoid dismissal of the complaint under the safe harbor, the trustee contended under Indiana law that the suit was not aimed at avoiding the transfer but only to recover the value of the transfer. Judge St. Eve responded by saying that the trustee was "attempting to invoke [state fraudulent transfer law] to obtain the same relief that § 546(e) otherwise precludes."

Federal Preemption

The collision between Section 546(e) and state law raised the question of federal preemption and whether it was "conflict preemption" or "obstacle preemption." There being no impossibility of enforcing both state and federal law, "conflict preemption" did not apply.

Judge St. Eve noted how the Second and Eighth Circuits "[b]oth held that § 546(e) preempts state law claims seeking to recover the value of transfers that the safe harbor shields." Persuaded by "our sister circuits," she said that holding otherwise would make Section 546(e) "meaningless" and would "wholly frustrate" the purpose behind the safe harbor.

Judge St. Eve affirmed the judgment of the district court calling for dismissal of the suit.

The opinion is *Petr v. BMO Harris Bank NA*, 23-1931 (7th Cir. March 15, 2024).


***The Second Circuit found discretion to avoid a constructively fraudulent transfer of exempt property that would have enabled the debtor to pay her creditors in full.***

# It's Ok to Avoid a Fraudulent Transfer Even if It Makes the Debtor Solvent, Circuit Says

The bankruptcy court has discretion to avoid a constructively fraudulent transfer of exempt property even if the result makes the debtor solvent and able to pay her creditors in full, the Second Circuit held in a September 29 opinion.

The New York-based appeals court issued its September 29 opinion against the backdrop of the Supreme Court's holding in *Tyler v. Hennepin County*, 143 S. Ct. 1369 (Sup. Ct. May 25, 2023), where the Court held that a real estate tax foreclosure can violate the Takings Clause of the Fifth Amendment when the municipality takes title but doesn't give the owner the difference between the unpaid taxes and the value of the property. To read ABI's report, click here.

On the split of circuits that led to *Tyler*, the Second Circuit was among those to have held that real estate tax foreclosures can be attacked as fraudulent transfers despite *BFP v. Resolution Trust*, 511 U.S. 531 (1994), where the Supreme Court ruled that mortgage foreclosures are immune from fraudulent transfer attack. *See County of Ontario, New York v. Gunsalus*, 37 F.4th 859 (2d Cir. June 27, 2022), *cert. denied*, 143 S. Ct. 447 (2022). To read ABI's report on *Gunsalus*, click here.

The Annuity and the Tax Foreclosure

Owning a 49-acre farm and residence, the debtor didn't pay $22,000 in real estate taxes in 2015. The county filed an *in rem* real estate tax foreclosure proceeding. On the debtor's default, the county obtained a judgment of foreclosure transferring the property to the county in 2017.

The county sold the property for $91,000 but refrained from transferring title to the buyer because the debtor had been appealing the default judgment in state court. However, the county kept some $69,000 in surplus funds after paying the $22,000 in taxes.

Just shy of two years after the tax foreclosure, the debtor filed a chapter 13 petition in March 2019. The debtor scheduled the foreclosed property among her property as being exempt and worth $186,000.

The debtor also scheduled ownership of an annuity of unknown value that she also claimed to be exempt. The debtor served the petition and schedules on the county.


The county did not object to the claim of exemption for the annuity. In the meantime, the debtor had sued the county to recover the home and farm as a constructively fraudulent transfer.

In the fraudulent transfer adversary proceeding, the county filed a motion *in limine* to admit evidence about the value of the annuity. Bankruptcy Judge Paul R. Warren of Rochester, N.Y., denied the motion *in limine*. He reasoned that the value of the annuity was irrelevant because it was not estate property to be considered in deciding whether the debtor was insolvent at the time of the tax foreclosure.

Later, Judge Warren ruled in favor of the debtor, avoiding the tax foreclosure. The district court affirmed. *See DuVall v. County of Ontario*, 21- 6236, 2021 BL 430732, 2021 US Dist. Lexis 216970, 2021 WL 5199639 (W.D.N.Y. Nov. 09, 2021). To read ABI's report, click here.

The county appealed to the Second Circuit.

The Definition of Insolvency

On appeal, the county contended it was error to have excluded evidence about the value of the annuity. The county believed that the annuity was worth enough to make the debtor solvent and therefore bar her fraudulent transfer under Section 548(a)(1)(B), because the debtor could not prove insolvency as required by Section 548(a)(1)(B)(ii)(I).

In his opinion for the Court of Appeals, Circuit Judge Raymond Lohier noted that neither the county nor anyone else had objected to the exemption of the annuity. "[I]f an interested party fails to object within the time allowed, a claimed exemption will exclude the subject property from the estate" under Section 522(l) and Rule 4003(b), Judge Lohier said.

Judge Lohier agreed with the bankruptcy court's holding that the annuity was exempt due to the lack of a timely objection to the exemption.

Next, Judge Lohier alluded to the definition of "insolvent" contained in Section 101(32)(A), which says that a debtor is insolvent if the debtor's "debts [are] greater than all of such entity's property, at a fair valuation, exclusive of . . . (ii) property that may be exempted from property of the estate under section 522 of this title."

Applying the definition, Judge Lohier said that the "plain text of the Code thus contemplates that insolvency is determined based on the debts and properties of and exemptions from the bankruptcy estate." Given the lack of an objection to the exemption, he found no error in denial of the county's motion *in limine* to exclude the value of the annuity from the determination of insolvency.


Excluding the annuity in the solvency determination, the bankruptcy court did not err in ruling that the debtor had shown the elements of a constructively fraudulent transfer, because the debtor was insolvent and had received less than reasonably equivalent value for the transfer.

The Proper Remedy

The county argued that the proper remedy wasn't avoiding the transfer. Instead, the county contended on appeal that the bankruptcy court should have awarded damages limited to the amount of the creditors' claims or the amount of the exemption.

To avoid what it called an "undeserved windfall" to the debtor, the county believed that the remedy should have been limited to rectifying the harm to creditors.

First, Judge Lohier said that "the County's proposal to limit [the debtor's] damages to the amount of creditor claims lacks support in the text of Section 522(h)." Likewise, he found "[n]othing in [Sections 522(h), 552(i)(1) or 550(a)] of the Bankruptcy Code . . . to limit the award of damages to the amount of creditor claims."

Finally, Judge Lohier addressed the county's contention that the bankruptcy court should have limited the remedy to the amount of the claimed exemption. On that score, he recounted how the parties agreed that the bankruptcy court had discretion between the two remedies.

Even if avoidance would be a windfall for the debtor, Judge Lohier noted how the Second Circuit in *Gunsalus* had "been critical of windfalls to creditors and debtors alike." Moreover, he said that allowing the county to retain the $69,000 would be a "defense . . . now unavailable in light of" *Tyler*.

Judge Lohier affirmed the judgment of the district court and upheld the avoidance of the transfer.

The opinion is *DuVall v. County of Ontario*, 21-2917 (2d Cir. Sept. 29, 2023).


***The insured's bankruptcy can allow other claimants to recover a preference from one claimant who drew down the policy limit.***

# Glomming On to an Entire Insurance Policy Can Be a Voidable Preference, Circuit Says

When claims against an insurance policy vastly exceed the policy limits, one tort claimant who empties the policy can be faced with receipt of a voidable preference if other claimants would receive nothing, according to the Fifth Circuit.

As Circuit Judge Stephen A. Higginson said in his October 6 opinion, the appeal arose from a "terrible tragedy."

A tractor-trailer owned by the debtor collided with a car, killing two occupants of the car. The debtor was covered by a $1 million insurance policy.

The family of one victim sued, but the family of the other didn't. Instead, the non-suing family demanded the policy limits from the insurer under what Judge Higginson called a *Stowers* demand.

In the settlement of the tort claim, the insurer acquiesced to the demand by paying out the $1 million policy limit to the IOLTA account of the claimant's lawyer. The same day, the insurance company notified the other family that the policy had been exhausted. A few days later, $320,000 went to the attorney for attorneys' fees, and $680,000 went to the claimant's family.

A week later, the family that received nothing filed an involuntary bankruptcy petition against the debtor. The trustee filed a preference suit under Section 547 against the family that received the settlement and the attorney for that family.

The lawyer and the family that settled filed a motion to dismiss, contending there was no preference because estate property was not used to make the payment. Specifically, Judge Higginson characterized the defendants as arguing that "the Debtor had neither legal title in nor a contractual right to receive the Policy Proceeds, and otherwise lacked control over their disbursement."

Chief Bankruptcy Judge Eduardo V. Rodriguez of the Southern District of Texas denied the motion to dismiss. He found that the $8 million in claims against the $1 million policy satisfied the "limited circumstances" test in *Martinez v. OGA Charters, L.L.C.* (*In re OGA Charters*), 901


F.3d 599 (5th Cir. 2018), giving the debtor an equitable interest in the policy proceeds, thereby classifying them as property of the estate.

When an appeal was filed by the family that was paid and their lawyer, the district court certified a direct appeal to the circuit, which the court of appeals accepted.

On appeal, the lucky family again argued that the debtor had no equitable property interest in the insurance proceeds. "But critically," Judge Higginson said,

> Appellants fail to contend with *In re OGA Charters*, in which we held that "[i]n the 'limited circumstances,' as here, where a siege of tort claimants threaten the debtor's estate over and above the policy limits, we classify the proceeds as property of the estate." 901 F.3d at 604.

Judge Higginson went on to say that *OAG*

> does not bestow upon the debtor a right to pocket the proceeds," but "[i]nstead . . . 'serve[s] to reduce some claims and permit more extensive distribution of available assets in the liquidation of the estate.'" *Id.*

Because "the present case is still clearly one in which 'the policy limit is insufficient to cover [the] multitude of tort claims' faced by the estate," Judge Higginson held that Bankruptcy Judge Rodriguez "correctly concluded that . . . the Policy Proceeds would be considered property of the estate."

In his holding, Judge Higginson said that Bankruptcy Judge Rodriguez correctly recognized that *OAG* only held that the insurance proceeds were estate proceeds, not a voidable transfer, because the insurance proceeds had not been distributed. In the case on appeal, the proceeds had been distributed two weeks before the involuntary filing.

Judge Higginson found that "this pre-petition payment of the Policy Proceeds does not affect the Debtor's equitable interest in them at the time the petition was filed." Were it not for the transfers, he said that the policy proceeds "would have been property of the estate."

Affirming, Judge Higginson upheld the ruling by Bankruptcy Judge Rodriguez "that the trustee had properly alleged a transfer of the Debtor's property as required by § 547."

Note

The family that received the payment argued in the circuit that *OAG* was wrongly decided because Texas law gives insureds no interest in insurance proceeds. In response, Judge Higginson said the panel was bound by circuit precedent.


Of greater importance, Judge Higginson said in a footnote that federal law governed, not state law. He noted that *OAG* "explicitly rejected" the same argument about controlling state law.

The opinion is *Law Office of Rogelio Solis PLLC v. Curtis*, 23-40125 (5th Cir. Oct. 6, 2023).


*Invoking Supreme Court authority, the Tenth Circuit says that inferences from the evidence are reviewed for clear error just like findings of fact themselves.*

# Earmarking Requires Dominion/Control and No Diminution of the Estate, Circuit Says

As it turned out, the Tenth Circuit Bankruptcy Appellate Panel correctly guessed about the showing that must be made to establish the so-called earmarking defense to preferences and fraudulent transfers in the Tenth Circuit.

To be valid, the defense indeed requires the debtor to have no dominion and control over the transferred property and that there must be no diminution of the estate.

However, the Tenth Circuit reversed the BAP and upheld the defense because the bankruptcy court's inferences from the facts were not clearly erroneous.

The Earmarked Loans

A corporation had confirmed a chapter 11 plan where unsecured creditors were to be paid in full before insiders' unsecured claims.

The company couldn't survive after confirmation without $450,000 in new loans made by the owner and chief executive. The company used most of the money to pay general unsecured creditors. In violation of the plan, however, the company used $50,000 to pay insiders on their claims that should not have been paid because they were subordinated by the plan.

The company failed a second time and ended up in chapter 7. The trustee sued the insiders to recover the $50,000 as preferences and fraudulent transfers.

Without contravention, the owner and chief executive testified that he would not have made the loans unless a portion was paid to insiders on their subordinated claims. The insiders raised earmarking as a defense, contending that the payments to them were not transfers of estate property, thus obviating preferences and fraudulent transfers.

Bankruptcy Judge David T. Thuma of Albuquerque agreed and entered judgment in favor of the insiders, dismissing the claims. The trustee appealed to the BAP and won a reversal.

Reading Tenth Circuit precedent on earmarking, the BAP concluded that the dominion/control test and the diminution-of-the-estate test were defenses. However, the BAP did not believe that


the appeals court had decided whether both tests must be met, or just one, before invocation of earmarking.

Ultimately, the BAP decided that the Tenth Circuit would require both the "dominion/control test and the diminution-of-the-estate test to determine whether there was a transfer of an interest of the Debtor in property." *Montoya v. Goldstein (In re Chuza Oil Co.)*, 639 B.R. 586, 599 (B.A.P. 10th Cir. May 27, 2022). However, the BAP decided that the insiders were not entitled to the earmarking defense because the debtor had control over the disposition of the loans and the payments to the insiders had diminished the bankrupt estate. To read ABI's report on the BAP opinion, click here.

The insiders appealed and won a reversal in a December 12 opinion by Tenth Circuit Judge Timothy M. Tymkovich.

Dominion and Control

The trustee's complaint alleged both preferences and fraudulent transfers. For transfers to be avoided, both Sections 547(b) and 548(a) require the transfer "of an interest of the debtor in property." Judge Tymkovich described earmarking as "a judicially created mechanism to determine whether the debtor had an interest in transferred property."

Like the BAP, Judge Tymkovich surveyed Tenth Circuit precedent and held that "earmarking applies if the transfers can satisfy both the dominion/control and the diminution tests."

Next, Judge Tymkovich analyzed whether the debtor had dominion and control over the loans. He alluded to uncontradicted testimony by the owner that he would not have made the loans unless some had been directed to insiders.

Based on the testimony, Judge Tymkovich pointed to the bankruptcy court's finding that the owner "placed a valid condition" on use of the loans. On "clear error" review, he set aside the BAP's conclusion to the contrary and held that the debtor "did not control the funds under our dominion/control test."

Diminution of the Estate

The bankruptcy court had found no diminution of the estate because the owner loaned significantly more than the payments to insiders. On the other hand, the BAP had relied on the same evidence to conclude there had been a diminution because subordinated creditors were paid before general creditors.

"On clear error review," Judge Tymkovich said, "we cannot disagree with the bankruptcy court's finding that the bankruptcy estate was not diminished by the combination of payments into


and out of [the debtor].” Elaborating, he said that the bankruptcy court had adopted the view that the payments to the insiders “didn’t harm other unsecured creditors because the payments had been conditioned on the infusion of extra cash into [the debtor].”

Judge Tymkovich said that the bankruptcy court had taken a “reasonable” inference that the infusion of new money did not diminish the estate. “Given the reasonableness of that inference,” he said, “the bankruptcy court’s finding is not clearly erroneous.”

According to Judge Tymkovich, “every circuit to [have] address[ed] the issue has considered the infusion of new money into the bankruptcy estate when determining whether later payments had resulted in a diminution.”

“Under clear-error review,” Judge Tymkovich ruled that “the bankruptcy court did not err in finding that [the debtor] did not control the earmarked funds, nor did the transfers diminish the estate.” Also agreeing with the bankruptcy court that the transfers were contemporaneous exchanges for new value, he “affirm[ed] the bankruptcy court’s rejection of the trustee’s claims involving improper preference and constructive fraud.”

Observations

The Tenth Circuit’s dissertation on the elements of an earmarking defense is not surprising. The opinion is perhaps more noteworthy for saying that the trier of fact’s inferences from the evidence are reviewed for clear error just like the findings of fact themselves.

On that topic, Judge Tymkovich cited *Anderson v. City of Bessemer City*, 470 U.S. 564 (1985). “Where there are two permissible views of the evidence,” the Supreme Court said, “the factfinder’s choice between them cannot be clearly erroneous.” *Id*. at 574.

The opinion is *Montoya v. Goldstein (In re Chuza Oil Co.)*, 22-2073 (10th Cir. Dec. 12, 2023).


***The 'new value' offered by old equity in a chapter 11 plan was insufficient because it was only a small fraction of claims and because the dividend to creditors was also small.***

# Judge Harner Gives Contours to the Amorphous Notion of 'New Value'

A "new value contribution" is a nonstatutory construct developed by courts as a counterweight to the so-called absolute priority rule in chapter 11, which precludes owners from retaining equity following confirmation if creditors object and are not paid in full.

A December 15 opinion by Bankruptcy Judge Michelle M. Harner of Baltimore gives definition to the amorphous notion of new value.

The corporate debtor began an attempted reorganization under Subchapter V of chapter 11. The debtor elected to proceed under "ordinary" chapter 11 after the Fourth Circuit held that debts of a corporate debtor in Subchapter V can be nondischargeable under Section 523(a). *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI's report, click here.

Had the debtor remained in Subchapter V, the absolute priority rule would not have applied even if a class of creditors had voted against the plan, but in "ordinary" chapter 11, the absolute priority rule came back to life.

The corporate debtor had sought chapter 11 relief to deal with a $4.7 million state court judgment against the debtor and its owner. Now under "ordinary" chapter 11, the debtor proposed a plan where the owner would retain ownership after confirmation.

The class of unsecured creditors voted overwhelmingly in favor of the plan, but the creditor with the $4.7 million judgment was in a class of its own and voted against the plan.

To overcome the absolute priority rule and retain ownership after confirmation, the owner offered new value described by Judge Harner as:

> (i) his sweat equity; (ii) the payment on his prepetition claim against the Debtor (arguably approximately $2,000 in wages and $47,000 in commissions); (iii) his $35,000 postpetition (and preconfirmation) loan to the Debtor; and (iv) $25,000 (presumably in cash) from his retirement account.


Analyzing the adequacy of the new value, Judge Harner explained that the absolute priority rule came into play under Section 1129(b), the so-called cramdown provisions in the Bankruptcy Code. It became applicable because a class voted against the plan. Section 1129(b)(1) says that "[t]he court . . . shall confirm the plan notwithstanding [a dissenting class] if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims and interests that is impaired under, and has not accepted, the plan."

"In simple terms," Judge Harner said that "the absolute priority rule requires that each class of impaired and unaccepting creditors be paid in full prior to any junior class of claims or interests receiving any distributions under the plan." She said that the new value theory "emerged to address the dilemma posed to prepetition equity holders of a chapter 11 debtor."

Judge Harner went on to say that the "general contours" of new value were "best described" by the Supreme Court in *Bank of America Nat'l Trust and Savings Ass'n. v. 203 North LaSalle Street P'ship*, 526 U.S. 434 (1999). There, the Court held that the provision of new value may not be offered only to existing equity holders "without consideration of alternatives."

"Unfortunately," Judge Harner said, "[l]ower courts have struggled to define appropriate 'alternatives' in the context of the new value exception."

For definition, Judge Harner decided to follow the Ninth Circuit's decision in *Bonner Mall P'ship v. U.S. Bancorp Mort. Co. (In re Bonner Mall P'ship)*, 2 F.3d 899 (9th Cir. 1993), *cert. granted sub nom. U.S. Bancorp Mortg. Co. v. Bonner Mall P'ship*, 510 U.S. 1039 (1994), *motion to vacate denied and case dismissed*, 513 U.S. 18 (1994). She characterized the five-factor test in *Bonner Mall* as requiring new value to be:

> (i) new, (ii) substantial, (iii) in money or money's worth, (iv) necessary for a successful reorganization, and (v) reasonably equivalent to the value of the stock being retained or received.

*Id.*, 2 F.3d at 908.

The debtor attempted to short-circuit application of the test by contending that the equity after confirmation would be worthless. Judge Harner disagreed. She said that the debtor was "a profitable business, has the ability to continue profitable operations in the future, and has particularly significant value to the [owner]."

Applying the test, Judge Harner said that sweat equity and debt forgiveness "are not considered 'new,' 'substantial,' or 'money or money's worth' under the case law," citing *Northwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988). She said:


> Courts place great emphasis on the proposed new value actually being "new" and in the nature of a fresh, outside capital infusion that will help pay creditors or otherwise aid the reorganization.

Similarly, Judge Harner said that repayment of the owner's loan from the debtor was not "new or money or money's worth" because "it must be repaid."

Judge Harner did find that the contribution of $25,000 from the owner's retirement account was new value. However, she said it was not "adequate new value," citing *In re Ambanc La Mesa Ltd. P'Ship*, 115 F.3d 650, 655 (9th Cir. 1997), where the Ninth Circuit compared the offered new value to the total unsecured claims, the claims being discharged and the dividend to unsecured creditors.

Judge Harner said that the $25,000 was about 0.5% of total claims and some 1.8% of the proposed distribution to creditors. "[P]erhaps more importantly," she said that the owner would retain all of the equity "while the Debtor pays creditors only 27% of their claims under a 60-month plan."

Judge Harner denied confirmation of the plan, holding that "the Debtor's plan fails the absolute priority rule of section 1129(b) of the Code."

The opinion is *In re Cleary Packaging LLC*, 21-10765 (Bankr. D. Md. Dec. 15, 2023).


# *Sales*


***The Fifth Circuit answered one of the two questions being posed at this year's Duberstein Moot Court Competition.***

# Avoidance Actions Are Estate Property that May Be Sold, the Fifth Circuit Says

In this year's Duberstein Moot Court Competition, being held in New York City March 2-4, one of the two questions being posed to the competitors is this:

> Whether a chapter 7 trustee may sell, as property of the bankruptcy estate, the ability to avoid and recover [preferential] transfers pursuant to 11 U.S.C. §§ 547 and 550.

Joining the Eighth and Ninth Circuits, the Fifth Circuit answered the Duberstein question by holding "that preference actions may be sold pursuant to 11 U.S.C. § 363(b)(1) because they are property of the estate under 11 U.S.C. §§ 541(a)(1) and (7)."

Allowing debtors to sell avoidance actions isn't entirely beneficial to an estate and its general creditors. If avoidance actions that arise after bankruptcy are estate property that is deemed to exist on the filing date under Section 541(a)(1), a prepetition secured lender might be able to obtain an enforceable lien on avoidance actions, taking valuable property away from the debtor and creditors. The lien could even sop up claims the debtor might wish to assert against the lender.

Assuming the three circuits have the correct answer on the right to sell avoidance actions, next year's Duberstein question might ask whether a prepetition secured lender may validly obtain a lien on avoidance actions that's enforceable after bankruptcy.

## The Sale of the Preference Action

The January 22 opinion by Circuit Judge James L. Dennis sets out the facts in elaborate detail. Just a few are pivotal.

Before bankruptcy, a corporate officer made an $800,000 loan to the debtor and was paid $320,000 before filing. During the chapter 11 case, the debtor filed a preference suit against the former officer under Section 547.

The debtor proposed a chapter 11 plan that sold the preference suit to a prepetition, secured lender. Specifically, the plan and the confirmation order assigned and conveyed the preference claim to the lender.


In return for the preference claim, the lender waived its lien on $700,000 in collateral and also waived the right to pursue an administrative claim. The lender had no obligation to return anything to the debtor were it to recover more than its secured claim.

Over objection by the preference defendant, the bankruptcy court confirmed the plan.

The reference having been withdrawn, the preference suit slogged ahead for three years in district court. On the eve of trial, the preference defendant filed a motion to dismiss for lack of subject matter jurisdiction under Rule 12(b)(1).

There being no explicit authority from the Fifth Circuit, the district court dismissed the suit, reasoning that the preference claim was not estate property under Section 541(a) and that the lender was not a "representative of the estate" under Section 1123(b)(3)(B).

The lender appealed to the Fifth Circuit.

Estate Property Under Section 541(a)(1)

Judge Dennis agreed with the district court when he said, "This question of whether preference claims may be sold is indeed a novel issue for this circuit." He also cited a Fifth Circuit opinion from 2010 where the appeals court said there was a split of authority on the ability to sell avoidance actions.

Judge Dennis first addressed the question of whether avoidance actions are estate property under Section 541(a)(1). The subsection says that estate property "is comprised of . . . all legal or equitable interests of the debtor in property *as of the commencement of the case*." [Emphasis added.]

To answer the question, Judge Dennis first cited *U.S. v. Whiting Pools Inc.*, 462 U.S. 198 (1983), where the Supreme Court held that estate property includes property that had been repossessed before bankruptcy in which the debtor had no possessory interest. He quoted the Supreme Court for saying that the section "is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code." *Id*. at 205.

After *Whiting Pools*, Judge Dennis cited his appeals court for saying that the scope of Section 541(a)(1) is "very broad" to include "conditional, future [and] speculative" property along with causes of action.

"Preference actions," Judge Dennis said, "are a mechanism in the Bankruptcy Code by which additional property is made available to the estate, fitting squarely within the *Whiting Pools*


definition." He held that "preference actions plainly fit the statutory definition of 'property of the estate' and may validly be sold under § 363(b)."

Estate Property Under Section 541(a)(7)

The lender also took the position that preference actions are estate property under Section 541(a)(7). It brings in "[a]ny interest in property that the estate acquires after the commencement of the case."

With little ado, Judge Dennis held that "the preference actions qualify as property of the estate under § 541(a)(7)."

Other Supporting Authority

Beyond the "clear statutory language," Judge Dennis said that his decision was "bolstered" by other courts, like the Eighth and Ninth Circuits, which have held that "the preference actions qualify as property of the estate under § 541(a)(7)." *See*, *e.g.*, *Pitman Farms v. ARKK Food Co. (In re Simply Essentials LLC)*, 78 F.4th 1006 (8th Cir. 2023). To read ABI's report on *Simply Essentials*, click here.

Judge Dennis said that *Simply Essentials* dealt with the preference defendant's "chief argument" that "avoidance powers are unique powers belonging to the trustee and that should not have been sold to someone who would not exercise those powers for the benefits of all creditors." He described the Eighth Circuit as having said that "the trustee's fiduciary duties require it to maximize the value of the estate, which may include and even require the sale of an avoidance action."

Judge Dennis saw the sale of avoidance actions as "the most equitable option," for instance, in cases where "the estate may not have sufficient funds to pursue preference actions." He therefore decided that "the sale of preference actions does not undermine the purpose of avoidance actions. Rather, it is consistent with the trustee's duty to maximize the estate."

Section 1123(b)(3)(B) Doesn't Matter

Even if avoidance actions are estate property, the preference defendant contended that the lender lacked standing because it was not an "estate representative" under Section 1123(b)(3)(B). The subsection provides that a chapter 11 plan may provide for "the retention and enforcement by the debtor, by the trustee, *or by a representative of the estate* appointed for such purpose, of any such claim or interest." [Emphasis added.]

"On the other hand," Judge Dennis said that Section 363(b)(3) allows a trustee or debtor in possession to "use" or "sell" estate property after notice and a hearing. Therefore, he said that


reliance on Section 1123(b)(3)(B) is "inapposite," because Section 363(b)(3) "provides different mechanisms by which a debtor-in-possession may liquidate its assets." He found "no requirement in 11 U.S.C. § 363 that the purchaser of a piece of the estate's property also be a representative of the estate."

Judge Dennis held "that preference actions may be sold pursuant to 11 U.S.C. § 363(b)(1) because they are property of the estate under 11 U.S.C. §§ 541(a)(1) and (7)." Even if the lender "does not qualify as a representative of the estate," he held that the lender "has standing to pursue the preference claim as it validly purchased the claim outright."

For the Fifth Circuit, Judge Dennis reversed and remanded.

Observations

The opinion is not altogether good news for debtors and creditors, because the decision opens the door for prepetition lenders to perfect liens on avoidance actions arising after bankruptcy. Why's that? The Fifth Circuit opinion and *Simply Essentials* could be read to mean that avoidance actions are property interests that exist before bankruptcy and could therefore be subject to lien.

Whether prepetition secured lenders can take liens on avoidance actions may not be a question answered entirely by the Bankruptcy Code, since a debtor must have an interest in collateral before a security interest can attach. Does an inchoate or contingent interest give rise to an interest in collateral sufficient to allow attachment before bankruptcy?

If a creditor claims to have a security interest in avoidance actions that had not attached before filing, the automatic stay would preclude attachment after filing, and Section 552(b) would not allow perfection after filing.

Debtors and creditors would have been better off if the opinion had been based entirely on Section 541(a)(7).

The opinion is *Briar Capital Working Fund Capital LLC v. Remmert (In re South Coast Supply Co.)*, 22-20536 (5th Cir. Jan. 22, 2024).


***Neither a sale 'free and clear' nor rejection of a union contract bars enforcement of NLRA successorship obligations, Delaware district judge rules in reversing the bankruptcy court.***

# Successorship Obligations Are Not Barred by Sales Free and Clear, Delaware D.J. Says

A district judge in Delaware reversed the bankruptcy court and held that a sale "free and clear" cannot insulate the buyer from its obligations under the National Labor Relations Act (NLRA) to bargain with the debtor's union once the buyer hires most of the debtor's employees.

The case before District Judge Gregory B. Williams had a sale order explicitly saying that the buyer would not be deemed a successor under labor law. He found no "bankruptcy loophole" allowing bankruptcy buyers to avoid union obligations after sales close.

The Watertight Sale Order

The debtor was a specialty steel manufacturer reorganizing under Subchapter V of chapter 11. The debtor sold substantially all of its assets to the buyer under Section 363(f) and an order conveying the property "free and clear of all liens, claims, rights, encumbrances and other interests of any kind or nature . . . and any rights and clams based on . . . successor or transferee liability." The labor union did not object to the sale.

That wasn't all; the sale order went on to say that the buyer "shall not be deemed" a successor under any theory of labor law liability. The sale order enjoined anyone from making claims for successor liability.

Alongside the sale of the assets, the union stipulated to the rejection of the existing union contract. However, the stipulation only resolved disputes between the union and the debtor.

The buyer hired substantially all of the debtor's employees but altered some of the terms of employment unilaterally. Immediately after the sale closed, the union requested that the buyer recognize the union as the employees' collective bargaining representative.

When the buyer refused, the union turned to the National Labor Relations Board (NLRB). The NLRB issued a complaint alleging that the buyer had failed to recognize and bargain with the union and had made unilateral changes in the terms of employment. Neither the NLRB nor the union alleged that the buyer was bound by the rejected union contract.


The buyer responded with a motion in bankruptcy court to enforce the sale order and enjoin the union from pursuing any claim based on an obligation that the buyer was obliged to recognize or bargain with the union.

The union objected to the motion, but the bankruptcy court granted the injunction, barring the union, directly or indirectly, from alleging that the buyer was bound by the rejected union contract or from circumventing the sale order. The union appealed the enforcement order.

In his September 18 opinion, Judge Williams said that neither the sale order nor the enforcement order prevented employees from electing a bargaining agent. So, the union petitioned the NLRB to hold an election. At the election, a majority cast votes in favor of the union, which was then certified as the workers' collective bargaining agent.

Judge Williams said that the buyer subsequently negotiated with the union.

Mootness

Alleging there was no longer a live controversy, the buyer contended that the appeal from the enforcement order was constitutionally moot because it was actively negotiating with the union.

However, Judge Williams pointed out that the buyer argued that the union was engaged in an ongoing violation of the bankruptcy court's enforcement order. He ruled that the enforcement order was "sufficiently 'alive'" if the order barred the union from alleging unfair labor practices based on actions after the sale but before the union election.

The buyer also argued that the appeal was statutorily moot under Section 363(m). Absent a stay pending appeal, the subsection says that the reversal or modification of a sale order on appeal "does not affect the validity of a sale or lease . . . ."

Judge Williams began by saying that the Third Circuit had rejected the idea that Section 363(m) "applies to every challenge of a sale order." He said that the union only seeks to vacate the enforcement order to "the extent that it enjoins the Union from seeking relief under the NLRA based on [the buyer's] post-sale conduct" and "does not implicate the terms of the sale itself."

The buyer retorted by saying it would not have purchased the business if the bankruptcy court had not extinguished its successor bargaining obligations. Judge Williams responded by saying that the buyer "misinterprets how federal labor law applies to the instant case."

Judge Williams explained that neither the sale order nor the purchase agreement required the buyer to hire the debtor's employees, thereby kicking in successor obligations under the NLRA.


He held that Section 363(m) was not applicable, because "the Union is not seeking to reverse or modify the sale itself, only to assert its rights based on [the buyer's] post-sale conduct."

NLRB's Jurisdiction over Post-Sale Conduct

The union argued that the NLRB had exclusive jurisdiction over the buyer's post-closing activities.

Indeed, "Federal courts have held that determinations of successorship obligations under federal labor law are committed to the NLRB," Judge Williams said. He cited the Second Circuit for holding "that the bankruptcy court lacked jurisdiction to resolve the question of successorship under the NLRA" and the Fifth Circuit for saying "that discharge could not shield the debtor from liability for his post-petition conduct rendering him a successor."

The Enforcement Order Improperly Enjoined the Union

The bankruptcy court had reasoned that the sale conveyed the business free and clear of any interests in the property, including the union contract. Further, the bankruptcy court believed that the union had consented to the sale free and clear of the union's interest under the union contract.

Judge Williams said that the bankruptcy court

> failed to appreciate that [the buyer's] status as a successor is not dictated by the [union contract] but rather determined under federal labor law based on its post-sale conduct, and that any statutory obligation to bargain with the Union before altering terms and conditions of employment was not an "interest in [] property" that could be extinguished.

Judge Williams cited copious authorities for the notion that the obligation to bargain exists independently of the union contract and that the bargaining obligations are not an interest in property. He also explained that the buyer's successorship obligations did not arise from the sale but from "a successor's conduct in hiring a majority of its workforce from the predecessor and maintaining substantial continuity in business operations."

Judge Williams said that he had not found, nor had the buyer cited, "any decision in any jurisdiction holding or suggesting that a sale under § 363(f) may preclude statutory obligations arising under the NLRA for post-sale conduct by a purchaser." He went on to say that there is "no decision holding that a § 363 sale order may insulate an entity from NLRA obligations arising post-sale, or violations of the NLRA resulting from post-sale conduct."

Judge Williams countered the buyer's contention that the union's consent to the sale free and clear obviated enforcement of successorship obligations. He said that "the Union could not have


consented to the Sale Order's alleged extinguishment of [the buyer's] successor bargaining obligation as such obligations under federal labor law only arise after specific post-sale conduct by a purchaser."

Citing the *Collier* treatise, Judge Williams said that the union's consent to rejection of the union contract "cannot shield the purchaser from successor liability arising out of its post-sale conduct."

Judge Williams reversed the bankruptcy court's order "to the extent that it enjoins the Union from seeking relief under the NLRA based on [the buyer's] post-sale conduct."

The opinion is *United Steel, Paper and Forestry, Rubber, Manufacturing, Energy Allied Industrial and Service Workers International Union, AFL-CIO, CLC v. Braeburn Alloy Steel LLC (In re CCX Inc.)*, 22-1563 (D. Del. Sept. 19, 2023).


# *Small Biz. Reorg. Act*


***A district judge in New York reversed a bankruptcy judge who had permitted a nonconsensual, nondebtor release in a Subchapter V case.***

# Nonconsensual, Nondebtor Releases Prohibited by a District Court in a Subchapter V Case

In December, we reported how a New York bankruptcy court made nonconsensual, nondebtor releases easier to obtain in Subchapter V than in large, mass tort chapter 11 cases.

District Judge Denise Cote rejected the bankruptcy court's report and recommendation, denied confirmation of the plan and wrote an opinion suggesting that nondebtor releases won't be available in Subchapter V (depending on how the Supreme Court rules in *Harrington v. Purdue Pharma L.P.*, No. 23-124 (Sup. Ct.)).

The Nondebtor Releases

The corporate debtor was a Broadway producer. Claiming it had not received its share of the income from a pair of productions, an investor initiated an arbitration against the corporate debtor and the individual who was the debtor's owner. The investor won an award of $2.9 million against the debtor and the owner, jointly and severally. The district court confirmed the award, which was automatically stayed for 30 days.

On the 29th day, the debtor corporation filed a chapter 11 petition under Subchapter V. In an adversary proceeding, the debtor convinced the bankruptcy judge to enter a preliminary injunction preventing the investor from enforcing the arbitration award against the owner.

Of course, the Subchapter V plan would discharge the corporate debtor's debt owing to the investor. But there was more.

The plan called for giving the owner a release from liability on the $2.9 million arbitration award. To justify the nondebtor release and allow the owner to retain ownership, the plan required the owner to supply $600,000 toward payments under the plan and to work for the debtor after bankruptcy.

Secured and priority claims of about $275,000 were to be paid in full on confirmation. Unsecured creditors with $300,000 in claims were to receive a portion of the debtor's disposable income over the duration of the plan.


In a class by itself, the unsecured investor with the $2.9 million claim was to receive a portion of the cash from the owner, plus a share of the debtor's disposable income over the life of the five-year plan. The plan would mean a haircut for the investor of some $2 million.

The unsecured class voted in favor of the plan, but the investor class voted against the plan, requiring the bankruptcy judge to consider confirmation as a cramdown under Section 1191(b).

Over objection by the investor and the U.S. Trustee, the bankruptcy judge recommended confirmation of the plan. *See In re Hal Luftig Co.*, 655 B.R. 508 (Bankr. S.D.N.Y. Nov. 22, 2023). To read about the bankruptcy court's rationale for imposing a nonconsensual, nondebtor release, click here.

Rejection of the Report Recommendation

The U.S. Trustee and the investor objected to the report and recommendation. District Judge Cote sustained their objections in an 11-page opinion on March 19.

Judge Cote began her review of the merits with a focus on the foundational authority for nondebtor releases in the Second Circuit, *In re Metromedia Fiber Network Inc.*, 417 F.3d 136 (2d Cir. 2005). She quoted *Metromedia* for saying that nondebtor releases are "proper only in rare cases." *Id*. at 141. She went on to say that the Second Circuit's most recent authority, *Purdue Pharma LP v. City of Grand Prairie (In re Purdue Pharma LP)*, 69 F.4th 45, 79 (2d Cir. May 30, 2023), set forth seven factors for courts to consider before imposing nonconsensual, nondebtor releases.

(Note to readers: The Supreme Court granted *certiorari* in *Purdue*. To read ABI's report on the December 4 oral argument in the Supreme Court, click here.)

Judge Cote went on to quote the Second Circuit for saying in *Purdue* that there may be cases where all seven factors are present, but the plan "should not be approved." *Id*.

On the "threshold question" of whether nondebtor releases are proper in Subchapter V cases, Judge Cote paraphrased *Metromedia* for saying that "courts are reluctant to permit nonconsensual releases outside of the context of asbestos litigation." *Metromedia*, *supra*, 416 F.3d at 142.

Focusing on the case at hand, Judge Cote said that "there is nothing unique about this small business bankruptcy that would set it apart from many others in which the debtor entity is closely connected to a non-bankrupt principal."

Judge Cote stopped short of precluding nonconsensual, nondebtor releases in all Subchapter V cases, because she found that the case failed one of the *Purdue* factors.


The sixth *Purdue* factor asks whether the impacted class voted "overwhelmingly" in favor of the plan and said that a 75% vote for the plan is "the bare minimum." *Purdue*, *supra*, 69 F.4th at 78-79.

The bankruptcy court conceded that the sixth factor was not satisfied but gave the objection little weight, since a Subchapter V plan may be confirmed without creditor consent. Judge Cote said, "The standard for confirming a small business bankruptcy . . . does not excuse the Bankruptcy Court from applying the critical *Purdue* factors."

Judge Cote addressed another rationale cited by the bankruptcy court for "minimizing" the sixth *Purdue* factor: the bankruptcy judge's conclusion that there would be no tangible harm from the nondebtor releases.

"This is clearly wrong," Judge Cote said, alluding to the fact that the investor would lose its rights to pursue collection of the arbitration award from the owner.

Judge Cote rejected the bankruptcy court's proposed findings of fact and conclusions of law, denied confirmation of the plan and remanded for "further proceedings consistent with this Opinion." She held, "Resolving these issues through a nonconsensual release within the Debtor's bankruptcy is not permissible."

The opinion is *In re Hal Luftig Co.*, 24-166 (S.D.N.Y. March 19, 2024).


***A decision from a New York bankruptcy court makes nondebtor releases easier to obtain in Subchapter V than in large, mass tort chapter 11 cases.***

# Sub V Plan with Nondebtor Release Approved over Opposition from the Affected Class

If the Supreme Court decides in *Purdue* that bankruptcy courts can issue nondebtor, nonconsensual, third-party releases, and if the district court approves the report and recommendation by Bankruptcy Judge John P. Mastando, III, Subchapter V will have a new, dramatic purpose: Procuring multimillion-dollar releases for the owners of small businesses when the businesses themselves have little other debt.

The corporate debtor was a notable Broadway producer. An individual was the sole owner and president of the corporate debtor.

An investor claimed it had not received its share of the income from a pair of productions. So, the investor initiated an arbitration against the corporate debtor and the owner. The arbitrator gave the investor an award of $2.9 million against the debtor and the owner, jointly and severally. The district confirmed the award, which was automatically stayed for 30 days.

On the 29th day, the debtor corporation filed a chapter 11 petition under Subchapter V. The debtor filed an adversary proceeding and persuaded Judge Mastando to enter a preliminary injunction preventing the investor from enforcing the arbitration award against the owner.

## The Plan

The debtor filed a chapter 11 plan to discharge the debtor's debt owing to the investor and give the owner a release from liability on the $2.9 million arbitration award. In return, the plan called for the owner to supply $600,000 toward payments under the plan.

The plan called for paying about $275,000 in secured and priority claims in full on confirmation. The unsecured investor with its $2.9 million claim was in a class of by itself and would receive a portion of the cash from the owner, plus a share of the debtor's disposable income over the life of the five-year plan.

Unsecured creditors with about $300,000 in claims would receive a *pro rata* share of the debtor's disposable income for the duration of the plan. The owner would receive no distribution but would retain ownership.


The plan required the owner to continue working for the debtor while spending half of his time on the debtor's affairs. In return, the debtor would be paid an annual salary of $210,000.

The unsecured class voted in favor of the plan, but the investor class voted against the plan, requiring Judge Mastando to consider confirmation as a cramdown under Section 1191(b).

In his November 22 opinion, Judge Mastando found jurisdiction to confirm the plan over objections by the investor and the U.S. Trustee. However, he read the Second Circuit's decision in *In re Purdue Pharma LP*, 69 F.4th 45 (2d Cir. May 30, 2023), *cert. granted sub nom. Harrington v. Purdue Pharma L.P.*, No. (23A87), 2023 WL 5116031 (U.S. Aug. 10, 2023), as requiring him to issue a report and recommendation to the district court regarding confirmation of the plan. (Note: *Purdue* will be argued in the Supreme Court on December 4.) To read ABI's report on *Purdue*, click here.

Because the arbitration award was a joint several liability of the debtor and the owner, Judge Mastando concluded that the plan would be a release of the investor's "direct" claims against the owner.

The Objections

Objecting to confirmation, the U.S. Trustee called the plan "abusive" and said it was not a "rare or unusual" case to warrant confirmation under Second Circuit authority. Judge Mastando quoted the U.S. Trustee as characterizing the release in favor of the owner as forcing "'an involuntary settlement upon [the owner's] primary creditor.'"

In objecting to confirmation, the investor contended that the plan would give the owner a "multimillion dollar gain" while causing the investor a "large financial loss." To the owner's way of thinking, a 37% recovery was not "fair payment."

Judge Mastando Confirms the Plan

Judge Mastando began his analysis of contested confirmation by quoting the Second Circuit in *Purdue* as "consistently" holding "that bankruptcy courts may approve non-consensual third-party releases of direct claims against a non-debtor so long as the release 'plays an important part in the debtor's reorganization plan.' *See Purdue*, 69 F.4th 45, 75–77 (2d Cir. 2023)." In his 65-page opinion, he proceeded to analyze the seven requisites in *Purdue* for confirmation of a plan with nonconsensual, nondebtor releases of direct claims.

Among the more pivotal *Purdue* tests applicable to the case before him, Judge Mastando dealt with them as follows:


*Necessity for Successful Reorganization*

While a plan "might" be confirmed without the releases, Judge Mastando said that success of the debtor's business was "almost entirely dependent" on the owner's continued participation that would be "severely" endangered were the investor to enforce the arbitration award against the owner.

*The Owner's 'Substantial' Contribution*

Judge Mastando found that the owner's cash contribution and his commitment to work for the debtor after confirmation were "substantial."

*'Overwhelming' Support from the Affected Class*

Judge Mastando conceded that the investor class's opposition meant that support from the class was "indisputably not 'overwhelming.'"

"Nevertheless," Judge Mastando said that the investor's objection "has little weight as to the propriety of a non-consensual third-party release here," based on two findings. First, he said that Subchapter V "itself contemplates the confirmation of a plan without the consent of any creditor."

Second, Judge Mastando apparently substituted his judgment for the investor's by saying "that the Plan is the best possible means of enabling [the investor's] recovery."

*'Fair' Payment for Enjoined Claims*

Judge Mastando found "that the Plan would provide all creditors with more than they would be able to collect from either the Debtor or [the owner] in any other situation." Finding that the plan would eliminate the cost and uncertainty were the investor to attempt collecting the award from the owner, he found "that the Plan provides for fair and equitable payment of the Released Claims."

*Equitable Considerations*

Judge Mastando found that "equity" supports confirmation of the plan with its nondebtor releases, in part because the owner and other creditors "will receive more under the Plan than in a chapter 7 proceeding, or in the event [the owner] filed for bankruptcy himself."

Judge Mastando rejected the U.S. Trustee's contention that the case did not present "exceptional circumstances." He also disagreed with the investor's contention based on the idea that it was not a "high-profile" mass tort case where "the vast majority" supported the plan.


Judge Mastando nonetheless found the case to be "unique" and "exceptional" because the investor was "apparently willing to . . . derail a Plan that would purportedly *optimize its own recovery* (and the recovery of every other creditor) in order to either drive the Debtor into Chapter 7 or drive the Debtor's principal into bankruptcy himself." [Emphasis in original.]

Provided that the debtor makes a minor modification in the plan, Judge Mastando overruled objections to the plan while reporting and recommending that the district court confirm the plan.

Observations

Will the district court consider Judge Mastando's recommendation before the Supreme Court rules on *Purdue*?

Even if the Supreme Court affirms *Purdue* and finds authority for bankruptcy courts to issue nondebtor releases, the district court must still consider whether Subchapter V has a peculiar attribute allowing the imposition of nondebtor releases despite overwhelming opposition from the affected class.

The opinion is *In re Hal Luftig Co.*, 22-11617 (Bankr. S.D.N.Y. Nov. 22, 2023).


***One month apart, two Houston bankruptcy judges held that a non-voting class is not deemed to have voted against a plan.***

# Two Judges Agree: A Class with No Votes Isn't Considered in Confirming a Sub V Plan

Two bankruptcy judges in Houston agree: In confirming a chapter 11 plan in Subchapter V, a non-voting, impaired creditor class will not be counted in deciding whether the debtor has satisfied Section 1129(a)(8), which requires that every class of creditors under a plan must be unimpaired or must have accepted the plan. If the non-voting class is deemed to have voted against the plan, the debtor must satisfy the so-called cramdown requirements.

Holding that non-voting classes are disregarded in deciding whether all classes have accepted a plan, Bankruptcy Judge Eduardo V. Rodriguez agreed with former Bankruptcy Judge David R. Jones in *In re Franco's Paving LLC*, 654 B.R. 107 (Bankr. S.D. Tex. Oct. 4, 2023). To read ABI's report on *Franco's*, click here.

## The Non-Voting Class

In the case before Judge Rodriguez, the Subchapter V plan had three classes: (1) a secured class with one creditor; (2) a class of unsecured creditors; and (3) a class for the secured claim of the Internal Revenue Service. The IRS did not vote, but creditors in the other two classes voted in favor of confirmation.

Anticipating that a class might not vote, the debtor's plan said in bold letters that a non-voting class would be assumed to have accepted the plan.

Raising the only objection to confirmation, the U.S. Trustee contended that the non-voting IRS class should be counted as having voted against the plan, compelling the debtor to satisfy the requirements for confirming a cramdown plan in Sections 1129(b) and 1191(b).

In his November 7 opinion, Judge Rodriguez held that the non-voting class could not be deemed to have accepted the plan, but he ruled that non-voting classes are not considered in deciding whether the class voted for or against the plan.

## No Deemed Acceptance


Judge Rodriguez "quickly" rejected the idea that a non-voting class is deemed to have accepted the plan. He found "no authority" for the proposition that Bankruptcy Rule 3018(c) is inapplicable in Subchapter V cases.

Titled "Form of Acceptance or Rejection," the rule provides that an "acceptance or rejection shall be in writing, identify the plan or plans accepted or rejected, be signed by the creditor or equity security holder or an authorized agent, and conform to the appropriate Official Form." The rule allows a creditor to vote for or against more than one plan and to rank competing plans in order of preference.

Judge Rodriguez found no merit in the debtor's argument that Rule 3018(c) is inapplicable in Subchapter V, because "the rule merely provides that an acceptance or rejection may be filed for each plan transmitted."

Next, Judge Rodriguez held "that Bankruptcy Rule 3018(c) precludes the use of plan language to deem non-voting creditors as having accepted the plan."

To rule that the plan provision was invalid, Judge Rodriguez relied on his prior decision in *In re Bressler*, 20-31024, 2021 WL 126184 (Bankr. S.D. Tex. Jan. 13, 2021), where he held that failure to cast a written vote constitutes neither acceptance nor rejection of a plan.

Non-Voting Isn't Implicit Acceptance

The debtor believed that a non-voting class implicitly accepted the plan. Judge Rodriguez disagreed, citing Section 1129(a)(8). One of the requisites for confirmation, the subsection provides that each class must be unimpaired or must have accepted the plan.

Judge Rodriguez held that the "attempt to treat a non-voting class as having implicitly accepted the plan similarly also contravenes" *Bressler*.

The Treatment of Non-Voting Classes

Judge Rodriguez found "significant disagreement" about the treatment of non-voting classes. Some courts view non-voting as acceptance; others see non-voting as rejection, and others don't count non-voting classes.

In *In re Ruti-Sweetwater, Inc.*, 36 F.2d 1263 (10th Cir. 1988), the Tenth Circuit held that a non-voting but impaired class is deemed to have accepted. The Denver-based appeals court noted how the former Bankruptcy Act treated a non-voting class as rejecting, but a similar provision was omitted from the Bankruptcy Code in 1978.


Although "some courts" have adopted *Ruti-Sweetwater*, Judge Rodriguez said that "most agree that a nonvote cannot be construed as an implicit acceptance." Like them, he held "that a nonvoting creditor class cannot be deemed to have implicitly accepted the plan."

Non-Voting Isn't Rejection

Courts rejecting *Ruti-Sweetwater* unanimously hold that the debtor must confirm by cramdown, Judge Rodriguez said. "[W]ithout providing critical analysis," he said that those courts equate non-voting with rejection.

"This court disagrees," Judge Rodriguez said, because acceptances and rejections must both satisfy the formality requirements in Rule 3018(c). He therefore dismissed the notion that a non-voting class rejects a plan.

Ignoring a Non-Voting Class

Judge Rodriguez followed the opinion of former Bankruptcy Judge David Jones in *Franco's*, *supra*, by holding that "a nonvoting class should not be counted for purposes of § 1126 and plan confirmation." He said that the "mathematical calculation required by § 1126(c) requires that the number of accepting votes be divided by total votes cast in a class."

When the numerator and denominator are both zero, the result would be "an unsolvable and undefined quotient," yielding a computation that "is absurd, unsolvable, and was not contemplated by Congress," Judge Rodriguez said.

Judge Rodriguez found himself left with "only one option: when an impaired class of creditors fails to cast a ballot, that class will not be counted for purposes of whether § 1129(a)(8) is satisfied." He found policy grounds for disregarding a non-voting class.

Requiring cramdown, Judge Rodriguez said, would force debtors and creditors "to shoulder the additional administrative burdens and expenses associated with cramdown merely because a creditor class was negligent or apathetic about asserting their rights." Invoking cramdown, he said, would "defeat[] the overarching policy preferences of Subchapter V."

Overruling the U.S. Trustee's objection, Judge Rodriguez disregarded the non-voting IRS class and confirmed the plan because the two voting classes had accepted the plan.

The opinion is *In re Hot'z Power Wash Inc.*, 23-30749 (Bankr. S.D. Tex. Nov. 7, 2023).


***Former Bankruptcy Judge David R. Jones disagreed with a colleague, who had held that a non-voting class is considered as having voted against a plan.***

# In Sub V, a Class with No Votes Isn't Considered in Confirming a Chapter 11 Plan

When no one in a class of creditors has voted for or against a Subchapter V plan, former Bankruptcy Judge David R. Jones of Houston holds that the class "will not be considered for purposes of 11 U.S.C. § 1129(a)(8)," which requires that every class of creditors under a plan must be unimpaired or must have accepted the plan, otherwise the so-called cramdown requirements are invoked.

The Subchapter V debtor's plan had six classes. Three classes voted to accept the plan, but there were no votes for or against the plan by creditors in the other three classes.

The classes with no votes covered a secured creditor, a creditor with a priority claim, and unsecured creditors.

As Judge Jones explained in his October 4 opinion, the U.S. Trustee argued that the "plan could not be confirmed under 11 U.S.C. § 1191(a) due to the failure of all classes to affirmatively accept the plan under 11 U.S.C. § 1129(a)(8) as required by 11 U.S.C. § 1191(a)."

As authority for the objection, the U.S. Trustee cited *In re Bressler*, No. 20-31024, 2021 WL 126184 (Bankr. S.D. Tex. Jan. 13, 2021), a decision by Bankruptcy Judge Eduardo V. Rodriguez, also of the Southern District of Texas.

Judge Jones marched through the requisites for confirmation of a Subchapter V plan contained in Section 1191(a), which requires the satisfaction of the requirements in Section 1129(a) other than subsection (15). Evidently, all of the confirmation requirements were met aside from subsection (8), which requires that every class must accept the plan or be unimpaired.

Because no one voted in the three classes, Judge Jones said that the mathematical "calculation required by § 1126(c) cannot be performed." He found that

> attempting to do what the laws of mathematics prohibit is an absurd proposition and could not have been intended when Congress enacted the current version of § 1126. By implementing a denominator that includes only votes actually cast in § 1126, it logically follows that Congress presumed that at least one vote was cast.


To buttress the idea that a vote must be cast, Judge Jones quoted the legislative history accompanying Section 1126, which said that the "amount and number are computed on the basis of claims actually voted for or against the plan, not as under Chapter X [of the former Bankruptcy Act] on the basis of the allowed claims in the class."

In an "unusual case" not contemplated by the statute, Judge Jones cited a Fifth Circuit decision from 1980 saying that the court should interpret the statute in line with "congressional intent" and "the statute's design." *Truvillion v. King's Daughters Hosp.*, 614 F.2d 520, 527 (5th Cir. 1980).

Judge Jones cited the Tenth Circuit for being the only circuit to address the question. *In re Ruti-Sweetwater, Inc.*, 836 F.2d 1263 (10th Cir. 1988). He paraphrased the Denver-based appeals court for holding "that by failing to cast a ballot, the non-voting creditors had consented to the debtor's plan and that their inaction amounted to a deemed acceptance. *Id*. at 1267–68."

Judge Jones cited one bankruptcy court in Texas for having followed *Ruti-Sweetwater* in 2009 and another Texas court for having rejected *Ruti-Sweetwater*, also in 2009.

For his part, Judge Jones found the "policy underlying *Ruti-Sweetwater*" to be "compelling." He referred to Subchapter V as being designed "to encourage consensual plans." From a "practical perspective," he said that "a creditor that agrees to a debtor's plan may express its consent by affirmatively voting for a plan or by simply choosing not to file an objection."

Judge Jones overruled the U.S. Trustee's objection and confirmed the plan. He held that a class with no votes "should not be counted for purposes of § 1129(a)(8)." In his view, "Congress presumed the existence of at least one vote in each class [in] making the change to § 1126 when enacting the Bankruptcy Code."

The opinion is *In re Franco's Paving LLC*, 23-20069 (Bankr. S.D. Tex. Oct. 4, 2023).


***Differing with eight lower courts, the Fifth Circuit sided with the Fourth Circuit by holding that debts of corporate debtors in Subchapter V can be nondischargeable in nonconsensual plans.***

# Fifth and Fourth Circuits Hold that Debts in Sub V Can Be Nondischargeable

Taking sides with the only other court of appeals to decide the question, the Fifth Circuit reversed the bankruptcy court on direct appeal and held that debts of corporate debtors in Subchapter V of chapter 11 can be nondischargeable under Section 523(a) in nonconsensual plans.

Beyond the language of the statutes, the Fifth Circuit saw Subchapter V as an example of congressional compromise. In return for omitting the absolute priority rule from Subchapter V, the New Orleans-based appeals court followed the Fourth Circuit by saying that Congress, as a compromise, made some debts nondischargeable as to corporate debtors.

## The Nondischargeability Complaint

The debtor was a corporation in Subchapter V of chapter 11. A secured lender filed a complaint contending that its claims were nondischargeable under Sections 523(a)(2)(A), 523(a)(2)(B), 1141(d) and 1192, because the debtor made a misrepresentation by not disclosing that bankruptcy was imminent.

In response to the complaint, the debtor filed a motion to dismiss for failure to state a claim under Rule 12(b)(6), contending that corporations in Subchapter V of chapter 11 may discharge debts that would be nondischargeable by individual debtors in Subchapter V.

The Fourth Circuit had already decided the issue in *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022), by holding that debts described in Section 523(a) can be nondischargeable as to corporate debtors, not just individual debtors, if the plan is nonconsensual. To read ABI's report on *Cleary*, click here.

Line by line, the bankruptcy court refuted *Cleary's* reasoning and granted the motion to dismiss. *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI's report, click here. The bankruptcy court authorized a direct appeal, which the Fifth Circuit accepted and held oral argument on December 5.


The Statutory Language

On the merits, Circuit Judge Stuart Kyle Duncan began his April 17 opinion by saying that "the dischargeability of its debts is governed by § 1141(d)" if "a debtor's bankruptcy plan is confirmed as a consensual plan under § 1191(a)." However, he said that the debtor's "plan was confirmed as a nonconsensual plan under § 1191(b), so the dischargeability of its debts is governed by § 1192."

Quoting Section 1192, Judge Duncan went on to say that confirmation discharges all debts in Section 1141(d)(1)(A) except, among other things, those "of the kind specified in section 523(a) of this title."

Judge Duncan identified a "textual conundrum," given that the preamble to Section 523(a) reads, "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 . . . ." [Emphasis in opinion.] He said that the preamble was "critical" to the bankruptcy court's conclusion that nondischargeability in Subchapter V applies only to individual debtors.

For Judge Duncan, "placing controlling weight" on the word "'individual' in § 523(a) disregards the plain language of § 1192(2)." He noted that Section 1192 deals with the discharge of debts of a "debtor," and that the word "debtor" in Subchapter V refers to "a person." In turn, "person" is defined in Section 101(41) to mean both an individual and a corporation.

"[P]utting all this together," Judge Duncan concluded that "§ 1192 applies to both individual and corporate debtors."

Next, Judge Duncan focused on the statutory language in "§ 1192[, which] excepts from discharge "any *debt . . . of the kind* specified in section 523(a)." [Emphasis in original.] He then said, "We must apply this precise language as written."

For Judge Duncan, "the most natural reading of § 1192(2) is that it subjects both corporate and individual Subchapter V debtors to the categories of debt discharge exceptions listed in § 523(a)." Like the Fourth Circuit "correctly reasoned," he said that "the reference to 'kind[s]' of debt in § 1192 serves as 'a shorthand to avoid listing all 21 types of debts' in § 523(a), 'which would indeed have expanded the one-page section to add several additional pages to the U.S. Code.'" *Cleary, supra*, 36 F.4th at 515.

In addition, he said that Section 1192(2) is "the more specific provision" that should govern the more general.

Like the Fourth Circuit, Judge Duncan said that nondischargeability "gains greater force when we situate § 1192 in the larger context of the Bankruptcy Code . . . . Even traditional Chapter 11


proceedings distinguish discharges for individual and corporate debtors." In addition, he said that Section 1192 is "virtually identical" to Section 1228(a), which courts have interpreted as allowing nondischargeability complaints as to corporate farmers.

"[M]ore importantly," Judge Duncan said, the debtor "misunderstands the compromises Congress made in Subchapter V," by which he was referring to the omission of the absolute priority rule in Subchapter V cases. "To counterbalance that benefit to debtors," he said, "Congress excepted from discharge 'any debt . . . of the kind specified in section 523(a).'"

Believing that accepting the debtor's arguments would "rewrite that compromise," Judge Duncan reversed and remanded, holding "that 11 U.S.C. § 1192(2) subjects both corporate and individual Subchapter V debtors to the categories of debt discharge exceptions listed in § 523(a)."

Observation

So far, eight lower courts, including the Ninth Circuit Bankruptcy Appellate Panel, have disagreed with *Cleary* and the result reached by the Fifth Circuit. To read ABI's report, click here.

The opinion is *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 25-50237 (5th Cir. April 17, 2024).


***Nondischargeability for Sub V corporate debtors is sub judice in the Fifth Circuit.***

# Eight Lower Courts Disagree with the Fourth Circuit on Sub V Nondischargeability

Other than the Fourth Circuit, all eight courts to have considered the issue have held that debts of corporate debtors in Subchapter V of chapter 11 cannot be nondischargeable under Section 523(a) in nonconsensual plans.

Reversing the bankruptcy court on direct appeal, the Fourth Circuit held that corporate debtors in Subchapter V may not discharge debts "of the kind" specified in Section 523(a). *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI's report, click here.

Precisely the same issue is *sub judice* in the Fifth Circuit, on direct appeal from a decision by Bankruptcy Judge Craig A. Gargotta of San Antonio. He disagreed with *Cleary* and held that "corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions." *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337, 344 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI's report on *GFS*, click here.

The Fifth Circuit heard oral argument on December 5 in *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 50-00237 (5th Cir.). The Fifth Circuit received several *amicus* briefs. The U.S. Department of Justice urged reversal with a ruling in line with the Fourth Circuit's. The National Association of Bankruptcy Trustees, among others, took the opposite position.

Soon, we will either have a split of circuits or two circuit courts bucking the trend set by bankruptcy courts around the country.

## The Issue Before Judge Timothy A. Barnes

Bankruptcy Judge Timothy A. Barnes of Chicago tackled the identical issue. The Subchapter V debtor was a corporation, and a creditor filed an adversary proceeding seeking a declaration that the debts owing to it were nondischargeable under Section 523(a)(2)(A), (a)(2)(B) and (a)(6).

The debtor filed a motion to dismiss. In an opinion on February 8, Judge Barnes called the topic a "*cause célèbre* in the bankruptcy world," alluding to how the issue was one of the questions for the 2023 Duberstein Moot Court Competition. Although admitting that the Fourth Circuit offered "one solution," he granted the motion to dismiss, saying that the "better position" was


taken by the Ninth Circuit Bankruptcy Appellate Panel in *Lafferty v. Off-Spec Solutions LLC (In re Off-Spec Solutions LLC)*, 651 B.R. 862 (B.A.P. 9th Cir. July 6, 2023). To read ABI's report, click here.

Whom to Follow — the Fourth Circuit or the BAP?

Judge Barnes saw the statute as "imprecise" but not "ambiguous." He began by saying that "nondischargeability under section 523(a) applies only to individuals." He went on to say that "Congress stated what should perhaps have been obvious from section 523(a)" when it said in Section 1141 that a "discharge under this chapter does not discharge a debtor who is an individual from any debt excepted from discharge under section 523 of this title."

But there was more. With the addition of the Small Business Reorganization Act in 2019, Congress added Section 1192. After the completion of plan payments, the section says that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title . . . except any debt . . . (2) of the kind specified in section 523(a) of this title."

Judge Barnes waded through *Cleary Packaging* to explain how the Fourth Circuit arrived at the conclusion that debts can be nondischargeable as to corporate debtors in Subchapter V. He also carefully parsed how the Ninth Circuit BAP reached the opposition conclusion in *Off-Spec Solutions*.

Judge Barnes said he was "not swayed by the reasoning of *Cleary Packaging*." He said it "projects rationales for Congress without evidence of the same, but it creates more problems for the statutes in question than it solves."

Viewing the statutes as "imprecise" but not "ambiguous," Judge Barnes said that "Congress did not through inartful language attempt to upset the existing, fundamental nature of chapter 11 or the Bankruptcy Code as a whole."

Judge Barnes granted the motion to dismiss, holding that "section 523(a) does not apply to the Debtor here."

The opinion is *Chicago & Vicinity Laborers' District Council Pension Plan v. R&W Clark Construction Inc. (In re R&W Clark Construction Inc.)*, 23-00127 (Bankr. N.D. Ill. Feb. 8, 2024).


***Disputing the Fourth Circuit line by line and raising the possibility of a circuit split, the BAP and six bankruptcy courts have held that there's no such thing as nondischargeability for corporate Sub V debtors.***

# Ninth Cir. BAP Holds that Debts of Corporate Sub V Debtors Can't Be Nondischargeable

All six bankruptcy courts to confront the question have held that debts of corporate debtors in Subchapter V of chapter 11 cannot be nondischargeable under Section 523(a) in nonconsensual plans.

The Ninth Circuit Bankruptcy Appellate Panel has joined the horde by affirming Bankruptcy Judge Noah G. Hillen of Boise, Idaho, in holding that debts can be nondischargeable in Subchapter V only when the debtor is an individual.

The bankruptcy judges and the BAP are aligned against the Fourth Circuit, which held that corporate debtors in Subchapter V may not discharge debts "of the kind" specified in Section 523(a). *Cantwell-Cleary Co. v. Cleary Packaging LLC (In re Cleary Packaging LLC)*, 36 F.4th 509 (4th Cir. June 7, 2022). To read ABI's report, click here.

Bankruptcy Judge Craig A. Gargotta of San Antonio disagreed with *Cleary* and held that "corporate debtors proceeding under Subchapter V cannot be made defendants in § 523 dischargeability actions." *Avion Funding LLC v. GFS Industries LLC (In re GFS Industries LLC)*, 647 B.R. 337, 344 (Bankr. W.D. Tex. Nov. 10, 2022). To read ABI's report on *GFS*, click here. The Fifth Circuit accepted a direct appeal in *GFS* in April. Briefing should be completed before September.

## The Facts in the BAP

The July 6 BAP opinion by Bankruptcy Judge Scott H. Gan reads like an *amicus* brief submitted in the Fifth Circuit in support of the debtor. Judge Gan refutes the Fourth Circuit's arguments, line by line, and concludes that dischargeability should be the same whether a corporate debtor is in "regular" chapter 11 or in Subchapter V.

The facts in the BAP case pull on the heartstrings in favor of nondischargeability, but the BAP resisted the urge to make bad law in a hard case.


The debtor allegedly suffered sexual harassment and discrimination at the hands of her corporate employer. She filed a complaint with the state employment commission and was awarded the right to sue after her former employer filed a chapter 11 petition and elected to proceed under Subchapter V.

The employee filed a claim accompanied by an adversary proceeding to declare the debt nondischargeable under Section 523(a)(6) as a willful and malicious injury. Judge Hillen dismissed the complaint for failure to state a claim.

Judge Hillen relied on his own previous decision in *Catt v. Rtech Fabrications, LLC (In re Rtech Fabrications, LLC)*, 635 B.R. 559 (Bankr. D. Idaho 2021), and on Judge Gargotta's *GFS* opinion. He was not persuaded by *Cleary*, nor was Judge Gan when the creditor appealed to the BAP.

The statutes are less than clear. Section 523(a) says, "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 for money obtained by false pretenses or fraud." [Emphasis added.]

Governing discharge for Subchapter V debtors, Section 1192 states that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A)." Subsection (2) of Section 1192 goes on to say that a discharge in Subchapter V does not cover "any debt . . . of the kind specified in section 523(a) of this title."

Finally, Section 1141(d)(1)(A) says that a "discharge under this chapter [11] does not discharge a debtor who is an *individual* from any debt excepted from discharge under section 523 of this title." [Emphasis added.]

Judge Gan said that Sections 523(a) and 1192 are "[f]acially" in "conflict." The "better interpretation," he said, "is that § 1192 reiterates § 523(a)'s application to debtors under subchapter V, and § 523(a) limits its applicability to individuals." Among other things, he said that "nothing in § 1192 obviates the express limitation in the preamble of § 523(a) or otherwise expands its scope to corporate debtors."

Noting that Congress amended Section 523(a) to add Section 1192 to the list of provisions to which it applies, Judge Gan said that accepting the Fourth Circuit's reasoning would render the amendment surplusage.

Judge Gan differed with the Fourth Circuit's idea that Section 1192, the more specific section, should control. He said that the canon of interpretation only governs when the statutes are irreconcilable, which they were not, in his view. And if they were irreconcilable, he saw Section 523(a) as being more specific, given that it applies in chapter 11 cases.


From a broader perspective, Judge Gan said that Subchapter V is part of chapter 11, "and its discharge provisions should be interpreted consistent with the overall statutory scheme in chapter 11." He noted that Congress had narrowed the corporate discharge only once, in the amendment adding Section 1141(d), and only after eight years of deliberation.

Judge Gan said it was "improbable" that Congress would have enacted such a major change in dischargeability in a bill that was introduced and adopted within one month in 2019.

Judge Gan differed with the Fourth Circuit's reliance on notions of fairness and equity to justify making debts nondischargeable in Subchapter V. Although the fairness idea was "plausible," he said it did not "comport with the purpose of facilitating reorganization of small businesses." Moreover, he said that making debts nondischargeable "is more likely to harm most general unsecured creditors by steering small businesses with nondischargeable debts toward liquidation."

In sum, Judge Gan saw the policy considerations in *Cleary* as "unavailing." He held "that § 1192 does not make debts specified in § 523(a) applicable to corporate debtors in subchapter V."

The opinion is *Lafferty v. Off-Spec Solutions LLC (In re Off-Spec Solutions LLC)*, 23-1020 (B.A.P. 9th Cir. July 6, 2023).


***Bankruptcy Judge Christopher Bradley disagreed with a district court in Florida that required a 'true up' if actual disposable income in Sub V exceeds projected disposable income.***

# Sub V Plan Doesn't Require Automatic Increases Based on *Actual* Disposable Income

Differing with a decision by a district judge in Florida 16 months before, Bankruptcy Judge Christopher G. Bradley of Austin, Texas, found "no general requirement for a subchapter V debtor to 'true up' its payments to its creditors when its actual income exceeds its projected disposable income."

The corporate debtor in Subchapter V of chapter 11 proposed a "cramdown" plan requiring payments starting out at $36,000 in the first year and rising to $216,000 in the fifth and last year of the plan. The Subchapter V trustee did not object to the debtor's calculation of "projected disposable income."

The Subchapter V trustee did object to confirmation because, as Judge Bradley said in his April 30 opinion, the plan "did not provide that the debtor had to pay more if actual disposable income exceeded projections."

There was a non-accepting class of unsecured creditors, meaning that the plan must comply with the cramdown requirements in Section 1191(b). The subsection permits confirmation if "the plan does not discriminate unfairly, and is fair and equitable." Under Section 1191(c)(2)(A), the plan is "fair and equitable" if, "as of the effective date of the plan," the "plan provides that all of the projected disposable income of the debtor . . . will be applied to make payments under the plan."

Judge Bradley paraphrased the statute as requiring "the debtor to devote its *projected* disposable income . . . to plan payments for three to five years." [Emphasis in original.] He went on to say that projected disposable income "accords with the 'forward-looking approach' that the Supreme Court has endorsed" in *Hamilton v. Lanning*, 560 U.S. 505, 519 (2010).

"To require a 'true up,'" Judge Bradley said, would "eliminate the future-looking element indicated by the word 'projected'" and "read the word 'projected' out of the statute." He found only one case requiring a "true up," *In re Staples*, 22-157, 2023 WL 119431 (M.D. Fla. Jan. 6, 2023). To read ABI's report on *Staples*, click here.


Judge Bradley observed that the district court in *Staples* found authority for a true-up in the All Writs Act and Section 105(a), which enables the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." He nonetheless said that the "*Staples* opinion does not support imposition of a true up either as a general rule or in this case."

First, Judge Bradley said that "the *Staples* opinion does not purport to announce a general rule requiring true ups." Second, he said that "the *Staples* opinion simply does not provide enough factual detail about that case to assess its similarities or differences with this Debtor's situation." He concluded that *Staples* does not provide "persuasive weight in favor of imposition of a true up."

Judge Bradley found support for his conclusion in cases under chapters 12 and 13, where, he said, the definition of "disposable income" is "substantially the same." In chapter 13, where there is "much more case law," he said that courts have "overwhelmingly ratified a prospective interpretation, that is, an interpretation requiring debtors to devote their projected income to plan payments, but not to 'true it up' if their actual income proves to be higher."

Judge Bradley cited the Eighth Circuit for taking a contrary position in a chapter 12 case, *Rowley v. Yarnall*, 22 F.3d 190 (8th Cir. 1994). He said that the "*Rowley* court admitted that its result was contrary to the text's plain meaning."

Citing "numerous courts and commentators," Judge Bradley said that *Rowley* "is not convincing." Furthermore, he said that *Rowley* "runs contrary to the Supreme Court's 2010 decision in *Hamilton v. Lanning*."

Judge Bradley also found it "telling that subchapter V provides no opportunity for any party other than the debtor to seek to modify the plan . . . . The debtor may be able to modify the plan to decrease the payments if reality falls short of expectations, but the projected income may be the ceiling for creditors in subchapter V cases."

Closing the opinion, Judge Bradley said that his decision "does not necessarily rule out the possibility that circumstances could arise under which a court would have the power to impose a true up." He saw no reason to address the question because "[n]o special circumstances have been alleged, and therefore no true up is warranted."

Judge Bradley overruled the objection and confirmed the plan.

The opinion is *In re Packet Construction LLC*, 23-10860 (Bankr. W.D. Tex. April 30, 2024).


***Bankruptcy court disregards SEC regulations defining 'voting securities' in deciding whether a Subchapter V debtor has 'affiliates' in bankruptcy.***

# For 'Sub V' Eligibility, Count the Debt of Affiliates Liquidating in Chapter 7

An individual debtor filed a chapter 11 petition and elected treatment under Subchapter V. The debtor owned two corporations that had been in chapter 7 for five and seven years, respectively.

Bankruptcy Judge Jeffery W. Cavender of Atlanta ruled that the debtor was ineligible for Subchapter V because the debt of the debtor exceeded $7.5 million when combined with the debt of the two companies long in chapter 7. In other words, companies in liquidation under the tutelage of chapter 7 trustees remain "affiliates" whose debt can make an owner ineligible for Subchapter V.

The December 13 opinion by Judge Cavender is apparently the first decision on the issue. We invite our readers to tell us whether they agree or disagree by providing remarks in the "comment" box at the foot of this story.

## The Debtor's Affiliates

The individual debtor elected treatment under Subchapter V on filing his own chapter 11 petition. Originally, the debtor disclosed that he was an affiliate of two companies that he had owned.

One of those companies had filed a chapter 11 petition in 2016, which was converted to chapter 7 in 2018. More than $50 million in proofs of claim were filed in that case. The debtor owned 65% of the stock of that company.

The debtor was the 99% owner of another company that had filed a chapter 7 petition in 2018.

The U.S. Trustee objected to the election made by the debtor-owner to proceed under Subchapter V, contending that the debt of the debtor and his two "affiliates" exceeded $7.5 million.

## The Burden of Proof

While there is a split of authority, Judge Cavender said that "a significant majority of courts" believe that the debtor bears the burden of proof to establish Subchapter V eligibility.


Judge Cavender decided that the debtor "bears the burden of proof on eligibility under Subchapter V," given "the clear trend . . . to place the burden on the debtor."

The Focus on "Voting Securities"

The outcome turned on the interpretation of Section 1182(1)(B)(i), which excludes a debtor from eligibility under Subchapter V if the debtor is a "member of a group of affiliated debtors under this title that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $7,500,000."

The term "affiliate" is defined in Section 101(2)(B) to mean a "corporation 20 percent or more of whose outstanding *voting securities* are directly or indirectly owned, controlled, or held with power to vote, by the debtor . . . ." [Emphasis added.]

The debtor took the position that he was not the owner of "voting securities" because the chapter 7 trustees took away whatever voting rights he had. Without meaningful voting power, the debtor said he held something less than "voting securities."

To that end, the debtor relied on a regulation promulgated by the Securities and Exchange Commission that says that the "term voting securities means securities the holders of which are presently entitled to vote for the election of directors." 17 C.F.R. § 230.405.

The debtor also pointed to legislative history in a House Report, which says that "affiliate" is "intended to cover situations where there is an opportunity to control" a debtor. H.R. Rep. No. 595, 95th Cong., 1st Sess. 309 (1977)).

The debtor also made an argument based on fairness, because courts have held that developments after filing don't affect a debtor's eligibility for Subchapter V on the filing date. For instance, in *In re Free Speech Systems LLC*, an affiliate with too much debt for Subchapter V later filed a petition under "ordinary" chapter 11, but the previously filed debtor-affiliate was entitled to remain in Subchapter V. *See, e.g.*, *In re Free Speech Systems LLC*, 649 B.R. 729, 733 (Bankr. S.D. Tex. March 31, 2023); and *In re Dobson*, 23-60148, 2023 BL 168846 (Bankr. W.D. Va. May 17, 2023). To read ABI's reports, click here and here.

Plain Language Prevails

Judge Cavender said that the debtor's arguments were "contrary to common bankruptcy usage and practice." He found no cases "even suggesting that an owner of 20% or more of a debtor's voting securities ceases to be an affiliate of a debtor in chapter 7 upon appointment of a trustee."


Next, Judge Cavender said that "the plain language of § 1182(1)(B)(i) includes debtors under all of title 11, not just debtors in non-chapter 7 cases or non-trustee cases."

Even if the SEC's definition of "voting securities" were appropriate, Judge Cavender said he was "not convinced that [the debtor] is not 'presently entitled to vote for the election of directors.'" In that vein, he recounted how the debtor offered "no authority suggesting [that the debtor] is not able to elect directors of a debtor in chapter 7, limited power though they may have."

Judge Cavender discounted *dicta* where he described the Supreme Court as having said "that a chapter 7 debtor's directors are 'completely ousted'" by a chapter 7 trustee. *Commodity Futures Trading Com v. Weintraub*, 471 U.S. 343, 352-53 (1985).

Even so, Judge Cavender said that "chapter 7 debtors have various obligations and retain various rights in a chapter 7 case, and someone must perform those obligations and exercise those rights on behalf of a corporate debtor." To the same effect, he said, "nothing in the definition of 'affiliate' or 'voting securities' requires that voting rights have value, and the rights can continue to exist even after a chapter 7 case is fully administered and closed."

Judge Cavender was also worried about opening "Pandora's Box" if he were to agree with the debtor. He had a "particular concern" that restricting the definition of "affiliate" would affect rules regarding venue and insider status.

Policy

Judge Cavender concluded his analysis by addressing "policy concerns." What if the two corporations had filed their chapter 7 petitions only five days before the debtor's filing in Subchapter V? If the filings had occurred so close together, he doubted that his "ruling would raise an eyebrow, or that [the debtor] would even make the argument."

"Where should the line be drawn?," Judge Cavender said. "What if it were five weeks, or five months?"

a"[E]ven from a pure policy perspective," Judge Cavender said that he was

> not convinced that owners of chapter 7 debtors with liabilities exceeding the Subchapter V debt limit are the type of small business debtors for whom Subchapter V was designed, or that excluding those owners from Subchapter V while their businesses are liquidated in chapter 7 is inherently unfair, even if the chapter 7 business cases take longer to administer than expected.

Summing up, Judge Cavender said that the "plain language of § 1182 provides that the aggregate liabilities of affiliated debtors under title 11 are to be considered when determining Subchapter V


eligibility." He sustained the U.S. Trustee's objection to the Subchapter V election, because he was "not persuaded that chapter 7 debtors were meant to be excluded from that affiliated group through the interpretation of 'voting securities.'"

The opinion is *In re Carter*, 23-54816 (Bankr. N.D. Ga. Dec. 13, 2023).


***If future liability on unexpired leases and executory contracts is counted, many companies will be ineligible for Subchapter V of chapter 11.***

# Courts Are Split on Counting Future Rent Toward the $7.5 Million Debt Cap in Sub V

Courts disagree on whether future liability on a lease counts toward the $7.5 million eligibility limit for Subchapter V.

Not counting future rent liability, Bankruptcy Judge Philip Bentley of New York disagreed with Bankruptcy Judge Klinette H. Kindred of Alexandria, Va., who knocked a debtor out of Subchapter V solely as a result of liability on a long-term lease. *See In re Macedon Consulting Inc.*, 652 B.R. 480 (Bankr. E.D. Va. June 14, 2023). To read ABI's report on *Macedon*, click here.

Judge Bentley sided with Bankruptcy Judge Thomas J. Catliota of Greenbelt, Md., who held that contingent liability on a lease is not counted in deciding whether the debtor has more than $7.5 million in debt. *See In re Parking Mgmt.*, 620 B.R. 544 (Bankr. D. Md. 2020).

In *Parking Management*, the debtor had moved to reject the lease on filing. Declining to consider the motion for rejection is consistent with cases holding that developments after filing don't affect a debtor's eligibility for Subchapter V on the filing date. *See, e.g.*, *In re Free Speech Systems LLC*, 649 B.R. 729, 733 (Bankr. S.D. Tex. March 31, 2023); and *In re Dobson*, 23-60148, 2023 BL 168846 (Bankr. W.D. Va. May 17, 2023). To read ABI's reports, click here and here.

## Too Much Debt for Sub V

The debtor operated a fertility clinic in midtown Manhattan. Expecting an expansion of the business, the debtor doubled the square footage in the office it was occupying. Plans went awry when the pandemic prevented the debtor from subleasing the new space until the fertility business had grown enough to utilize the additional floors.

Having fallen in arrears on paying rent, the debtor ultimately filed a chapter 11 petition and elected treatment as a small business debtor under Subchapter V. After spending several months negotiating with the landlord, the debtor filed a motion to reject the lease, which Judge Bentley granted.


Meanwhile, the landlord had objected to the debtor's Subchapter V eligibility, saying there was more than the $7.5 million cap contained in Section 1182(1)(A). Judge Bentley sustained the objection in his November 30 opinion, but not based on long-term lease liability.

Rather, Judge Bentley gauged eligibility by combining the debts that the debtor had scheduled as undisputed and proofs of claim filed by creditors to which the debtor had lodged no objections. As Section 1182(1)(A) requires, Judge Bentley was looking for the "aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition."

Judge Bentley decided that the debtor was ineligible for Subchapter V because undisputed and scheduled claims exceeded $7.5 million when "grossing up" undisputed, scheduled claims to the amounts sought in the creditors' proofs of claim to which the debtor had not objected.

The Landlord's Alternative Argument

Alternatively, the landlord cited *Macedon* and contended that the debtor had more than $7.5 million in debt based solely on future rent. For reasons shown below, Judge Bentley concluded that "future payment obligations under its unexpired leases and executory contracts should rarely, if ever, be counted toward the subchapter V debt cap."

Judge Bentley began his analysis by referencing the definition given by the Second Circuit to "noncontingent" and "liquidated" in *Mazzeo v. United States (In re Mazzeo)*, 131 F.3d 295 (2d Cir. 1997). He quoted *Mazzeo* for saying that

> "a debt is contingent if it does not become an obligation until the occurrence of a future event, but is noncontingent when all of the events giving rise to liability for the debt occurred prior to the debtor's filing for bankruptcy." *Id.* at 303 (2d Cir. 1997).

Again citing *Mazzeo*, Judge Bentley said that a debt is liquidated if "the amount could be easily ascertained." *Id*. at 304.

Judge Bentley said that *Macedon* used the same definitions to count post-petition rent, but he declined to reach the same result because "that decision overlooks the distinctive nature of a debtor's obligations under its executory contracts and unexpired leases, which differ in key respects from other debtor obligations."

As a matter of policy, Judge Bentley was disinclined to follow *Macedon* because "many debtors otherwise eligible for that subchapter are parties to long-term leases or contracts with future payment obligations well in excess of $7.5 million."


Judge Bentley looked at executory contracts and unexpired leases from three points of view. If they are assumed, he said it's "doubtful" whether the future obligations should even be considered "debts."

If the debtor has neither assumed nor rejected, Judge Bentley said that "the amount and nature of its obligations under that contract or lease are contingent and unliquidated."

If a lease or contract is rejected, Judge Bentley said, "it could be argued that the debtor's rejection damages liability is a noncontingent debt as of [the filing date] for purposes of the subchapter V debt limit." For example, he said there may be factual disputes about the amount of rejection damages.

Judge Bentley pointed to *Parking Management*, where he characterized Judge Catliota as holding that lease liability remains contingent until the court grants the debtor's motion to reject.

Like *Parking Management*, Judge Bentley said that "the Debtor did not move to reject the Lease until after the petition date." Therefore, he said that the "eventual liability under the Lease was contingent and unliquidated as of [the filing] date [and was] not properly counted toward the subchapter V debt cap."

Another Approach

Courts may also wish to consider state law. Unless there has been a default and acceleration, some states would say that liability on a lease or a mortgage arises month to month. For instance, the statute of limitations begins to run every month when a lease or mortgage payment comes due. Thus, the statute may have run on payments due years earlier, but there can be new claims arising every month that are not time-barred.

Perhaps there is no debt to count toward the $7.5 million cap with regard to payments in the future where the statute has not begun to run.

Courts may also find guidance from Generally Accepted Accounting Principles (GAAP). To deal with a lease on a balance sheet, there is a short-term liability for payments due in 12 months and a long-term liability. There is also an asset called a "right of use asset," which offsets the future liability on the lease. Thus, leases are disclosed on a balance sheet, but there is no net liability to depress the company's net worth.

If GAAP doesn't show future rent as a net liability, why should bankruptcy law?

The opinion is *In re Zhang Medical PC*, 23-10678 (Bankr. S.D.N.Y. Nov. 30, 2023).


***Future liability on a lease was counted as a liquidated, noncontingent debt in calculating whether the Subchapter V debtor had more than $7.5 million in debt.***

# All Future Liability on a Lease Counted for Subchapter V Eligibility

If followed by other courts, a decision by Bankruptcy Judge Klinette H. Kindred of Alexandria, Va., could knock some debtors out of Subchapter V solely as result of liability on long-term leases.

In her June 14 decision, Judge Kindred distinguished a decision by Bankruptcy Judge Thomas J. Catliota of Greenbelt, Md., who held that the contingent liability on a lease is not counted in deciding whether the debtor has more than $7.5 million in debt. *See In re Parking Mgmt.*, 620 B.R. 544 (Bankr. D. Md. 2020).

The debtor was a software developer who ran into bad times during the pandemic. With employees working from home, the debtor needed less office space. On filing in chapter 11 and electing treatment under Subchapter V, the debtor filed a motion to reject the office lease.

The rent owing throughout the remainder of the term of the lease was $14.4 million. The landlord moved to dismiss the case as a bad faith filing. Short of dismissal, the landlord wanted Judge Kindred to declare that the debtor was ineligible for Subchapter V, counting the remaining rent under the lease.

The debtor countered by saying that future rent was contingent on the filing date and that the lease claim shouldn't be more than the capped rejection claim under Section 502(b)(6).

For Subchapter V eligibility, the outcome was controlled by Section 1182(1). It requires the debtor to have:

> noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition. . . in an amount not more than $7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

Judge Kindred said that the parties found no cases "directly on point." *Parking Management* was the closest. There, the debtor moved to reject leases alongside the filing of the petition. Evidently, lease-rejection damages would make the debtor ineligible for Subchapter V.


Because rejection was dependent on action by the court after filing, Judge Catliota held that the rejection claims were contingent and thus not included in the eligibility calculation.

Judge Kindred distinguished *Parking Management* for having only focused on rejection damages that were contingent. She said, "that does not mean this Court will ignore the Debtor's existing pre-petition liability under the Leases in favor of post-petition events when determining eligibility." Absent rejection, she said that the debtor would owe $14.4 million under the lease.

"In this case," Judge Kindred said, liability on the lease arose before filing when the lease was executed. Therefore, she held that liability on the lease "must be considered noncontingent and liquidated," making the debtor ineligible for Subchapter V. She also rejected the idea of counting only the capped lease claim.

Believing that other creditors would not benefit from dismissal, Judge Kindred revoked Subchapter V eligibility but allowed the debtor to continue under "regular" chapter 11.

Together with granting the debtor's motion to reject the lease, Judge Kindred also denied the landlord's motion to dismiss for a bad faith filing. She held that the landlord had not shown both subjective bad faith and objective futility, as required by the Fourth Circuit in *Carolin Corp. v. Miller*, 886 F.2d 693 (4th Cir. 1989).

On subjective bad faith, Judge Kindred found nothing wrong with a debtor who files bankruptcy to reject a lease and cap damages. On objective futility, she said that the debtor's 100% plan may require "some tweaks" but "cannot find that the restructuring in this case is objectively futile."

Questions

On signing a lease, is the lessee immediately liable under state law for all of the rent during the term of the lease? Or, is the lessee only liable each month for that month's rent when the rent comes due?

If a debtor is current on a lease on filing a Subchapter V petition, is there any debt to count with regard to the $7.5 million cap for eligibility?

Is the debtor liable under state law for all remaining rent if the debtor was in default on filing? Or, is the debtor liable only for the amount in arrears?

If the debtor moves to assume and cure lease defaults, how much is there in lease liability? If the debtor moves to reject a lease, is Subchapter V liability based on the capped rent claim?

The opinion is *In re Macedon Consulting Inc.*, 23-10300 (Bankr. E.D. Va. June 14, 2023).


***Courts are split on whether the debt providing eligibility for Sub V must have arisen from a business that was active on the filing date.***

# Eligibility for Subchapter V Is Liberal, but Not Wide Open

An opinion by Bankruptcy Judge Robert E. Littlefield, Jr. of Albany, N.Y., is a mixed bag for individuals aiming to qualify for reorganization under Subchapter V of chapter 11.

Fending off a lawsuit arising from a defunct business supplies one element of eligibility for Subchapter V, but Judge Littlefield's June 2 opinion also requires the debtor to show that half of total debt must have arisen from the particular business relied upon for eligibility.

The individual debtor filed a chapter 11 petition and elected treatment under Subchapter V. She owned or had owned two businesses. The debtor had no debt arising from one of the businesses that was evidently still in existence, but she had almost $700,000 in debt arising from a business that was no longer operating.

Specifically, the debtor had been the owner of a business that defaulted on a lease. The debtor was being sued on her personal guarantee of the lease. The landlord filed a claim for about $700,000 on the guarantee.

Total debt was almost $1 million, so everyone agreed that 50% or more of her debt had arisen from one of the businesses, satisfying one of the criteria for Subchapter V.

The landlord objected to the debtor's eligibility for Subchapter V, contending that the debtor was not engaged in business at the time of filing. The Subchapter V trustee supported the debtor's eligibility.

The outcome turned on the definition of a Subchapter V debtor. Pertinent to the case before Judge Littlefield, Section 1182 requires the debtor to have:

> noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date . . . in an amount not more than $7,500,000 . . . not less than 50 percent of which arose from the commercial or business activities of the debtor.

## Currently Engaged in Business or Not?


Judge Littlefield first confronted the question of whether the debtor must have been engaged in "commercial or business activities" as of the filing date. He said that a majority of bankruptcy courts found "a temporal restraint and require the eligibility analysis to review the debtor's activity as of the petition date." He cited, among others, *Nat'l Loan Invs., L.P. v. Rickerson (In re Rickerson)*, 636 B.R. 416, 424-25 (Bankr. W.D. Pa. 2021); and *In re Offer Space LLC*, 629 B.R. 299, 305-06 (Bankr. D. Utah 2021). To read ABI's reports, click here and here.

Judge Littlefield therefore held "that the Debtor must demonstrate she was presently engaged in commercial or business activities as of the Petition Date."

Next, Judge Littlefield examined the "totality of the circumstances" to understand whether the debtor was engaged in business on the filing date. He said that "most courts" interpret the statute broadly "to provide wide availability for debtors to elect to file under subchapter V," citing *In re Ikalowych*, 629 B.R. 267, 276-77 (Bankr. D. Colo. 2021). To read ABI's report, click here.

Citing *In re Port Arthur Steam Energy, L.P.*, 629 B.R. 233, 237 (Bankr. S.D. Tex. 2021), Judge Littlefield held that a "debtor can qualify for subchapter V absent the company's traditional business operations where the company is winding down." To read ABI's report, click here.

Applying the law to the facts, Judge Littlefield said that the debtor was defending a lawsuit on her personal guarantee of the commercial lease. He held that defense of the suit on the "personal guaranty . . . is sufficient winding down activity for the Debtor to satisfy the 'engaged in commercial or business activities' requirement of § 1182(1)(A)."

Nexus Between the Business and the Debt

Judge Littlefield turned to a question on which courts are split: Is it sufficient if 50% of the debt arose from all of the debtor's businesses, or must more than 50% have arisen from the specific business making the debtor eligible for Subchapter V?

Once again citing *Ikalowych* and calling it the "seminal case," Judge Littlefield held that 50% or more of the debt must have arisen from the business that qualifies the debtor for Subchapter V.

In the case before him, the debtor had $700,000 in debt from her guarantee of the personal debt from the business that made her eligible for Subchapter V. He allowed the debtor to proceed in Subchapter V.

The opinion is *In re Hillman*, 22-10175 (Bankr. N.D.N.Y. June 2, 2023).


***The $7.5 million debt cap for Subchapter V doesn't include the debt of affiliates who file later.***

# Bankruptcy Judges Agree: Later Developments Don't Undo Subchapter V Eligibility

Bankruptcy judges in Virginia and Texas agree: Subsequent events do not unravel eligibility for Subchapter V.

Specifically, Bankruptcy Judge Rebecca B. Connelly of Harrisonburg, Va., held that a debtor's eligibility for Subchapter V is determined as of the filing date. Even if an affiliate files bankruptcy the next day with more debt than Subchapter V permits, the first debtor to file remains eligible to reorganize under Subchapter V.

A husband and wife filed a chapter 11 petition and elected to proceed under Subchapter V. The husband was the sole owner and manager of a corporation. The next day, the corporation filed a chapter 7 petition.

The U.S. Trustee agreed that the husband and wife, standing alone, were eligible for Subchapter V because their combined debt did not exceed $7.5 million. However, the couple and the corporation were affiliates under Section 101(2). If the corporate debt were added to the individuals' debt, the combined debt would exceed $7.5 million, making the couple ineligible for Subchapter V.

If it matters, the couple first consulted an attorney regarding a bankruptcy filing by the corporation. Evidently, counsel advised the couple that they should file first under Subchapter V, because a prior filing by the corporation would relegate them to "ordinary" chapter 11.

The U.S. Trustee filed a motion aimed at forcing the individual debtors to proceed under "ordinary" chapter 11 because their debt, when combined with the corporation's, exceeded $7.5 million. Judge Connelly denied the motion in her May 17 opinion.

The U.S. Trustee admitted that the couple by themselves were eligible for Subchapter V under Section 1182(1)(A) because they were engaged in commercial activity and had not more than $7.5 million in debt "as of the date of the filing of the petition," of which not less than 50% arose from commercial activity.

The sticking point, according to the U.S. Trustee, was Section 1182(1)(B)(i). It bars a debtor from Subchapter V if it is a "member of a group of affiliated debtors under this title that has


aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $7,500,000."

The U.S. Trustee argued that the court must consider eligibility based on events that occur postpetition, because the words "as of the date of the filing of the petition" appear in subsection (1)(A) but not in subsection (1)(B).

Judge Connelly disagreed. She said that the "language of section 1182 does not direct a court to determine petition eligibility based on postpetition events." More specifically, she said:

> Section 1182 does not say the conditions are ongoing, include postpetition events, or persist "throughout the case," nor does section 1182 contain any other language to provide that the debtor's eligibility is not determined as of the initiation of the case under subchapter V.

The U.S. Trustee contended that a recent amendment adding the words "under this title" to Section 1182(1)(B)(i) means that eligibility is a continuing qualification. Again, Judge Connelly disagreed. She said it was added to make the statute

> abundantly clear that the term "debtors" in section 1182(1)(B)(i) is not limited to a group of affiliated debtors which are all proceeding under subchapter V — it was made clear that the debt of any affiliate debtor under any chapter be counted in the calculation.

Judge Connelly rejected the idea that the debtors filed in bad faith because they put themselves into bankruptcy just one day before the affiliated corporation. She said that "the U.S. Trustee has failed to show how professional advice and deliberate planning of the timing of a bankruptcy petition is unlawful or abusive."

On the merits, Judge Connelly said she agreed with Bankruptcy Judge Christopher Lopez of Houston and his decision in *In re Free Speech Sys., LLC*, 649 B.R. 729, 733 (Bankr. S.D. Tex. 2023). To read ABI's report, click here. Like Judge Lopez, she held:

> A later event does not make a statement made as of the petition date incorrect. It does not change the eligibility as of the petition date. The debtor is either eligible or not. He does not change his existence during the case.

To bolster her holding, Judge Connelly pointed out the problems that would arise if eligibility were a continuing question. For example, obtaining post-petition financing could push the debtor's debt above $7.5 million. Or, dismissal of an affiliate's case might make a sister debtor once again eligible for Subchapter V.


Judge Connelly ended her opinion by pointing out the advantages that Subchapter V bestows on creditors. In Subchapter V as opposed to "ordinary" chapter 11, creditors will have a larger recovery because the debtor pays no fees to the U.S. Trustee. Confirming a plan takes "appreciably" less time, and creditors benefit from the guidance of the Subchapter V trustee.

Judge Connelly denied the motion of the U.S. Trustee, finding that the debtors had established eligibility for Subchapter V.

The opinion is *In re Dobson*, 23-60148 (Bankr. W.D. Va. May 17, 2023).


# Consumer Bankruptcy


# *Discharge/Dischargeability*


***An alter ego may be of the same ilk as a partnership or agency, so there may be no inconsistency between the Fifth Circuit opinion and the Bartenwerfer concurrence.***

# Fifth Circuit Expands *Bartenwerfer* to Saddle *Alter Egos* with Nondischargeable Debts

The Fifth Circuit expanded *Bartenwerfer* by holding a debt to be nondischargeable when the debtor was neither a partner nor an agent nor the person who himself committed the fraud.

The October 16 opinion might not be a big deal because the debtor was found to be the *alter ego* of the corporation that committed the fraud. Perhaps *alter ego* rises to the same level as a partner or agent.

The Fifth Circuit's decision brings into question whether the "understanding" in the *Bartenwerfer* concurring opinion will hold water. Justices Sonia Sotomayor and Ketanji Brown Jackson concurred, based on the belief that a debtor who did not commit fraud would be saddled with a nondischargeable debt under Section 523(a)(2)(A) only in cases of partnership and agency.

Misappropriated Construction Funds

A contractor who files bankruptcy after not paying subcontractors is begging to be sued for a declaration that the debt is nondischargeable. That's what happened here.

To build his home, a homeowner hired the construction company owned by the debtor. When all was said and done, it turned out that the debtor's construction company had taken down $761,000 in draws from the owner but had paid subcontractors only $193,000. The subcontractors filed liens for nonpayment. On giving draw requests to the owner, the debtor's corporation's bookkeeper had issued certificates saying that the subcontractors' bills would be paid.

The owner sued the debtor and his corporation in state court for, among other things, breach of contract, fraud and violation of the Texas Construction Trust Fund Act, which says that construction payments are "trust funds" and that an "owner" who has control of trust funds "is a trustee of the funds."

While the suit was pending, the debtor filed a chapter 7 petition. The debtor withdrew the state court suit to bankruptcy court.


The owner responded to the bankruptcy by filing an adversary proceeding to declare that the debt was nondischargeable under Section 523(a)(2)(A) and (a)(4). The former makes a debt nondischargeable for "any debt . . . for money, property [or] services . . . to the extent obtained by . . . false pretenses, a false representation, or actual fraud."

Under Section 523(a)(4), a debt is nondischargeable for "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."

The debtor invoked an arbitration clause and sent the removed state court suit to arbitration. After a four-day hearing with witnesses, the arbitrator awarded the owner about $370,000 in damages, plus $200,000 in attorneys' fees.

The arbitrator found the corporation liable for fraudulent misrepresentations but found insufficient evidence to hold the owner liable for misrepresentations. Nonetheless, the arbitrator concluded that the owner was the corporation's *alter ego*, making him personally liable for the misrepresentations.

The bankruptcy court confirmed the arbitration award. On cross motions for summary judgment, the bankruptcy court decided that the debt was dischargeable. The district court reversed, prompting the debtor's appeal to the Fifth Circuit.

The *Per Curiam* Opinion

In a *per curiam* opinion, the Fifth Circuit panel said it was "greatly assisted by the Supreme Court's recent decision in *Bartenwerfer v. Buckley*, 589 U.S. 69 (2023). There, the Court confirmed that § 523(a)(2)(A) can extend to liability for fraud that a debtor did not personally commit."

The appeals court went on to note that the Supreme Court had focused "'on how the money was obtained, not who committed fraud to obtain it.' *Bartenwerfer*, 598 U.S. at 72."

Similarly, the panel noted how Texas corporate law does not limit the liability of an owner who has used a corporation to perpetrate actual fraud for the direct, personal benefit of the owner. To that, the circuit court added the arbitrator's finding that the owner should be held personally liable for the corporate misrepresentation on account of his *alter ego* status.

"[G]iven the arbitrator's determination of [the owner's] liability for [the corporation's] misrepresentations," the Fifth Circuit held that "*Bartenwerfer* supports § 523(a)(2)(A)'s application here" to render the debt nondischargeable under Section 523(a)(2)(A).

Nondischargeable Under Section 523(a)(4)


Focusing on defalcation as grounds for nondischargeability under Section 523(a)(4), the circuit court referred to *Bullock v. BankChampaign, N.A.*, 569 U.S. 267, 273–74 (2013), where the Supreme Court held that defalcation requires "an intentional wrong."

The appeals court referred to the arbitrator's finding that the owner misapplied trust funds intentionally, knowingly and with intent to defraud and thus demonstrates "that [the owner] had the requisite scienter."

The circuit court therefore also ruled that the debt was nondischargeable under Section 523(a)(4).

Observations

Justices Sotomayor and Jackson based their concurrence in *Bartenwerfer* on the "understanding" that fraud is imputed only to "agents" and "partners within the scope of the partnership." *Bartenwerfer*, *supra*, 143 S. Ct. at 677.

Notably, the Fifth Circuit's opinion did not mention the *Bartenwerfer* concurrence. Because the concurrence is not law, the appeals court had no obligation to deal with the concurrence.

The Fifth Circuit opinions gives rise to two questions: (1) Will other courts follow the *Bartenwerfer* concurrence; and (2) is an *alter ego* finding the equivalent of partnership or agency or an even more proper basis for finding nondischargeability?

The opinion is *Kahkeshani v. Hann (In re Hann)*, 22-20407 (5th Cir. Oct. 16, 2023).


***A debtor has one bite at the apple to enforce discharge. Take your pick: state or federal court, but not both.***

# *Rooker-Feldman* Even Bars Review of State Court Judgments that Are 'Void,' Circuit Says

After discharge, state and federal courts have concurrent jurisdiction to decide whether a debt was discharged.

Allowing a state court to decide a discharge question is risky, for reasons shown in a Fifth Circuit opinion: If the state court is wrong, the bankruptcy court is stuck with the state court's judgment and can't right the wrong.

Criminal Restitution

The debtor evidently passed bad checks at casinos. A casino won a judgment for some $250,000 against the debtor well before he filed a chapter 7 petition. The state began a criminal prosecution two years after the debtor's bankruptcy filing. Later, the debtor made a plea agreement.

More years after discharge, the state court convicted the debtor of a misdemeanor and obliged the debtor to pay restitution of about $220,000 to the casino with the judgement that had been discharged in bankruptcy.

When the casino moved in state court to enforce the restitution award, the debtor opposed by contending that the debt had been discharged.

The state court rejected the debtor's affirmative discharge defense, relying on *Kelly v. Robinson*, 479 U.S. 36 (1986). In *Kelly*, the Supreme Court held that criminal restitution was nondischargeable under Section 523(a)(7), even though it was payable to the victim of the crime, because (1) the victim had no control over the decision to award restitution or the amount of the award, and (2) the decision to impose restitution turned on the penal goals of the state, not the victim's injuries.

The debtor did not appeal the state court's decision but instead reopened his bankruptcy case and sought a declaration that the debt had been discharged.

Sitting in Sherman, Texas, Bankruptcy Judge Brenda T. Rhoades reopened the case but denied the motion to declare the debt discharged, alluding to the *Rooker-Feldman* doctrine. Named for


two Supreme Court decisions, *Rooker-Feldman* bars lower federal courts from engaging in appellate review of state court judgments for lack of subject matter jurisdiction.

The district court affirmed, and so did the Fifth Circuit in a *per curiam*, nonprecedential opinion on January 30.

*Rooker-Feldman*

The Fifth Circuit conducted *de novo* review of dismissal under *Rooker-Feldman* for lack of subject matter jurisdiction.

The appeals court said that the "case present[ed] the 'paradigm' *Rooker-Feldman* situation: the losing party in state court thereafter commenced a proceeding in federal court, complaining of injury by the state-court judgment and seeking review and rejection of it by the federal court."

The debtor contended that *Rooker-Feldman* did not apply because the judgment was void under Section 524(a)(1), which "voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727 . . . ."

"But, in this case," the Fifth Circuit said, "the state court specifically determined that the restitution payable to [the casino] fell under § 523(a)(7) of the Bankruptcy Code, which excepts restitution orders from bankruptcy discharge orders."

The circuit court rejected the contention, saying that the "'void judgment' argument challenges the merits of the state-court judgment, which we are precluded from reviewing."

The appeals court affirmed denial of the debtor's motion to enforce the discharge for lack of jurisdiction.

The opinion is *Gilani v. Wynn Las Vegas LLC (In re Gilani)*, 23-40477 (5th Cir. Jan. 30, 2024).


***The Second Circuit split with the First Circuit, which had permitted nationwide class actions because the discharge injunction is statutory.***

# Second Circuit Nixes Nationwide Class Actions for Discharge Violations

Holding that a bankruptcy court may not enforce a discharge order entered in another district, the Second Circuit nixed the idea of a nationwide class action alleging contempt of the discharge injunction.

The Second Circuit found support for its holding by extrapolation from *Taggart v. Lorenzen*, 139 S. Ct. 1795,1799 (2019), where the Supreme Court held that a bankruptcy court may hold a creditor in civil contempt when there is objectively "no fair ground of doubt" that the creditor violated the discharge injunction. To read ABI's report on *Taggart*, click here.

In the August 2 opinion, the Second Circuit said that "expanding a bankruptcy court's civil contempt powers with respect to discharge orders [] may likely be good policy. But courts must take statutes as they find them, and, as written, the [Bankruptcy] Code leaves intact the longstanding equitable principles regarding the enforcement of injunctions."

The Purported Nationwide Class Action

Having scheduled a bank as having a claim for about $1,100, the debtor filed a chapter 7 petition. The bank received notice of the filing and the debtor's discharge.

A few months after discharge, the debtor pulled her credit report to find that the $1,100 debt was still listed as "written off" rather than "discharged." The debtor demanded that the bank notify the credit reporting agency that the debt had been discharged. According to the debtor, the bank refused.

After the debtor reopened her chapter 7 case, the bank removed the "charged off" notation.

The debtor filed a purported nationwide class action in the New York bankruptcy court where she had received her discharge. The complaint alleged that the bank had continued reporting discharged debts as "charged off" to harm the debtors' credit ratings and coerce the debtors to repay discharged debts.


The bank filed a motion to compel arbitration under an arbitration clause in the credit card agreement. The bankruptcy court denied the arbitration motion, and the district court affirmed.

On the first appeal to the Second Circuit, the appeals court held that contempt proceedings for violation of the discharge injunction are not arbitrable and are in the exclusive jurisdiction of the bankruptcy court. *GE Capital Retail Bank v. Belton (In re Belton)*, 691 F.3d 612 (2d Cir. June 16, 2020). To read ABI's report, click here.

[Note: ABI's report on *Belton* said that the opinion contained "strongly worded *dicta* that the bankruptcy court may not maintain a nationwide class action to rectify violations of the discharge injunction."]

On remand to the bankruptcy court, the bank filed a motion to dismiss for failure to state a claim and to strike the class action allegations. The bankruptcy court denied the motion to dismiss and rejected the bank's plea to strike the class allegations. The district court certified a direct appeal, which the circuit accepted.

Class Action 'No'; Plausible Claim 'Yes'

In his opinion for the appeals court, Circuit Judge Richard C. Wesley framed the question as whether one bankruptcy court has authority to enforce discharge orders entered by "other bankruptcy courts across the country." He said that *Taggart* was "instructive," referring to the Supreme Court's holding that contempt powers of the bankruptcy court incorporate "traditional standards in equity practice." *Taggart, supra*, 139 S. Ct. at 1801.

In other words, Judge Wesley said that the contempt powers of bankruptcy courts are no greater than the powers "wielded by courts outside of bankruptcy." Next, he cited the "longstanding equitable principle" that the issuing court is the only court responsible for sanctioning contumacious conduct. Indeed, he said, "Plaintiff fails to offer a single example of one court exercising its civil contempt authority on behalf of another court's injunction."

The notion of nationwide class actions on discharge violations, Judge Wesley said, is "in tension with our repeated observation that 'a bankruptcy court has "unique expertise in interpreting its own injunctions and determining when they have been violated."' *In re Gravel*, 6 F.4th 503, 513 (2d Cir. 2021)."

Judge Wesley admitted that discharge orders "might often be issued on standard forms," but he said that "the appropriateness of civil contempt sanctions, and in what form, are considerations that can still benefit from the unique insight a bankruptcy court can gain in presiding over a proceeding."


"In any event," Judge Wesley said, "*Taggart* does not suggest that the statutory basis of the discharge injunction is of any significance in determining its manner of operation or how it might be enforced."

Judge Wesley said that the debtor "seeks a bankruptcy-specific expansion of the civil contempt power beyond its longstanding limits at equity." Although Congress could intervene, he said that departing from "long tradition" is not "lightly implied," citing the Supreme Court.

Following the "cautionary approach" in *Taggart*, Judge Wesley held, "A bankruptcy court's civil contempt authority does not extend to other bankruptcy courts' discharge orders in a nationwide class action."

Having stricken the class action allegations, Judge Wesley turned to the question of whether the debtor had alleged a plausible claim of discharge violation.

Among other arguments, the bank contended that the complaint failed to state a claim because the bank had sold the debt. Judge Wesley rejected the argument, declining "to impose a rule whereby creditors can avoid their obligations under a discharge order by covertly passing their debt off to third parties."

Judge Wesley found that the debtor had satisfied the *Taggart* standard because the complaint "plausibly alleges that [the bank's] refusal to correct her tradeline was objectively, and purposively, coercive."

Circuit Split

Although the Second Circuit did not cite *Bessette v. Avco Fin. Servs.*, 230 F.3d 439 (1st Cir. 2000), the decision from the First Circuit arguably gives rise to a split of circuits. *Bessette* reversed an order barring a class action except in the court that issued the discharge and could be read to hold that discharge is a statutory injunction, not one crafted for an individual case.

Note also that the case before the Second Circuit opened "Pandora's Box" in the manner that worried the dissenters in *Coinbase Inc. v. Bielski*, 143 S. Ct. 1915, 216 L. Ed. 2d 671 (Sup. Ct. June 23, 2023). To read ABI's report, click here.

In *Coinbase*, the Supreme Court held that denial of a motion to compel arbitration automatically imposes a stay on the entire action in the trial court, pending appeal from the order denying arbitration.

Credit card agreements and consumer loan documents often contain arbitration clauses. If a debtor claims injury by a lender's attempt to collect a discharged debt, the bankruptcy court likely will deny an arbitration motion under Second Circuit authority like *Belton*.


In future cases of alleged discharge violations, will bankruptcy courts be obliged to halt proceedings for contempt until there is a final order on appeal from denial of the arbitration motion? In a case like the one before the Second Circuit, will a debtor be unable to enforce the discharge injunction (or perhaps the automatic stay) until two layers of appellate courts have ruled on the arbitration motion?

Just imagine how arbitration motions could muck up bankruptcies, consumer and chapter 11!

The opinion is *Citigroup Inc. v. Bruce*, 22-1000 (2d Cir. Aug. 2, 2023).


***The Fourth Circuit declined to follow the First and Sixth Circuits on preemption of automatic stay violations by expanding the ban to redress for discharge violations.***

# Fourth Circuit: State Law Claims for Discharge Violations Are Not Preempted

Although the lower courts are split, the Fourth Circuit became the first court of appeals to rule that the Bankruptcy Code does not preempt claims under state law for violation of the discharge injunction. However, the panel itself was split 2/1.

The dissenter would have found preemption by analogy to decisions from other circuit courts that found preemption barring state law claims for violations of the automatic stay.

A man filed a chapter 13 petition in 2011 and confirmed a plan. Two years later, the debtor modified his plan and surrendered his home. Plan payments completed, the debtor received a discharge in 2016, with the effect of discharging his personal liability on the home mortgage.

According to the debtor, the holder of the mortgage began violating the automatic stay before discharge by repeatedly making calls and sending letters demanding payment of the mortgage. The lender's efforts to collect the mortgage continued after discharge in 2016, the debtor claimed.

The debtor sued the lender in federal district court in 2020, based on violations of the discharge injunction. The complaint asserted claims for emotional distress under state law and for violation of a state consumer protection statute for attempting to collect an invalid debt. The complaint also made claims under the federal Fair Credit Reporting Act and the Telephone Consumer Protection Act.

The district court granted the lender's motion for summary judgment, ruling that the state law claims were preempted by the Bankruptcy Code. Regarding the federal and state claims, the district court granted summary judgment in favor of the lender, finding no disputed issues of fact.

Setting aside summary judgment in favor of the lender in an opinion on August 18 for himself and Chief Circuit Judge Albert Diaz, Circuit Judge A. Marvin Quattlebaum, Jr. ruled there was no federal preemption and disputed issues of fact on the state law claims.

Preemption


Because the state law claims all required proof of violation of the discharge injunction, the district court found preemption, believing that the ability to hold the lender in contempt under Section 105(a) provided the debtor's sole remedy. However, the district court did not specify which version of preemption applied.

Judge Quattlebaum said that express preemption did not apply and that the lender made no argument that field preemption barred the suit. Therefore, conflict preemption was the only possibility, and conflict preemption comes in two varieties: direct conflict preemption and obstacle preemption.

Direct preemption requires showing that compliance with state and federal law is impossible. In the case on appeal, Judge Quattlebaum said that compliance with both was "easy," meaning that "direct conflict preemption does not apply." Obstacle preemption, he said, is "trickier."

No other circuit has discussed obstacle preemption in the context of a discharge violation, Judge Quattlebaum said. However, the First and Sixth Circuits have held that obstacle preemption bars state law claims for violation of the automatic stay, given the availability of contempt sanctions meted out by the bankruptcy court under Section 105(a).

For there to be obstacle preemption, Judge Quattlebaum said that the court must first divine "Congress's 'significant objectives'" and then decide "whether the state law stands 'as an obstacle to the accomplishment of a significant federal regulatory objective.'"

The principal objective of the Bankruptcy Code is to provide the debtor with a "fresh start," Judge Quattlebaum said. The debtor's "state law claims create no obstacle to providing him with a fresh start."

On the other hand, Judge Quattlebaum said that the lender's "best argument" was based on the idea that the Bankruptcy Code features "centrality of administration." Since the discharge violations occurred after the bankruptcy case was closed and did not impact any order issued during the case, he could not "see how they detract from the ease or centrality with which the federal bankruptcy system operates."

Next, Judge Quattlebaum dealt with the notion that the Bankruptcy Code prescribes contempt under Section 105(a) as the sole remedy for a discharge violation, but he saw "no reason why the mere fact that state law claims provide broader remedies than federal law means the state claims are preempted."

"Since § 105(a) is neither specific to discharge injunction violations nor comprehensive," Judge Quattlebaum rejected the idea of obstacle preemption because the possibility of a contempt citation "is not the type of Congressionally designed balance that implicates obstacle preemption."


In a pregnant footnote, Judge Quattlebaum said that "[e]ven a more comprehensive remedial scheme may not guarantee obstacle preemption."

Next, Judge Quattlebaum dealt with the lender's argument that the Bankruptcy Clause of the Constitution means that Section 105(a) is the exclusive remedy. To the contrary, he said that the Bankruptcy Clause "is about empowering Congress to enact bankruptcy laws and ensuring that federal bankruptcy laws themselves do not vary impermissibly from state to state."

"In sum," Judge Quattlebaum said, the debtor's state law claims "do not create an obstacle to the goals of the Bankruptcy Code" and "are not preempted."

Disputed Facts

Backing up the finding of federal preemption, the district court had ruled in favor of the lender across the board with regard to summary judgment by finding no material factual disputes. With one exception, Judge Quattlebaum reversed, finding disputed facts.

Regarding the debtor's claims under state consumer protection law, the lender relied on language in written communications saying they were only for informational purposes. Judge Quattlebaum found there were disputed facts because transcripts of telephone calls to the debtor did not contain disclaimers, and the debtor said the lender was demanding payment in full.

Similarly, Judge Quattlebaum found disputed facts regarding claims under the Fair Credit Reporting Act. However, he upheld summary judgment with regard to claims under the Telephone Consumer Protection Act, because there was no evidence that the lender made automated calls.

In short, the majority vacated the district court's ruling on preemption and summary judgment on the claims under state law and the Fair Credit Reporting Act.

The Dissent

Circuit Judge James Andrew Wynn dissented "respectfully" regarding preemption, believing "it was Congress's intent to preempt these types of claims." He based his conclusion in part on the Bankruptcy Clause and on decisions from the Sixth and Ninth Circuits holding that state law claims for violation of the automatic stay were preempted.

Judge Wynn saw "no reason why state-law claims alleging violations of a discharge injunction should be treated differently" from claims for automatic stay violations. He also saw centrality of administration as a "principal purpose" of the Bankruptcy Code.

Judge Wynn believes that Congress designed the Bankruptcy Code so a state court would not "wade into the underlying bankruptcy proceeding" to decide whether a debt was discharged. He


also said that a bankruptcy court could award "traditional damages and attorneys' fees." The availability of contempt, he said, "keeps state courts from wading into potentially thorny issues of bankruptcy law."

[Note: Judge Wynn did not deal with a state court's concurrent jurisdiction to decide whether a debt was discharged.]

Believing that the state law claims should have been preempted, Judge Wynn concurred in the remainder of the majority's opinion finding disputed issues of fact.

The opinion is *Guthrie v. PHH Mortgage Corp. (In re Guthrie)*, 22-1248 (4th Cir. Aug. 18, 2023).


***Fourth Circuit holds that attorneys' fees and interest in pursuit of nondischargeable debts are themselves nondischargeable.***

# Agreements in Settlement of Nondischargeable Debts Are Themselves Nondischargeable

The Fourth Circuit holds that the debt in a settlement agreement based on a claim for willful and malicious conduct is nondischargeable under Section 523(a)(6) and isn't a dischargeable debt arising from breach of contract.

Of perhaps more significance, the Fourth Circuit also held that the costs of enforcing the settlement agreement and interest from delayed payment are likewise nondischargeable.

Long before bankruptcy, the debtor allegedly assaulted the creditor. In lieu of litigating, they settled. The agreement obliged the debtor to pay $415,000 over time, with interest on late payments.

The debtor made $186,000 in payments before stopping. The debtor filed a bankruptcy petition just after the creditor filed a motion for a default judgment. The creditor filed both a proof of claim and a complaint seeking a declaration that the remaining payments were nondischargeable under Section 523(a)(6) along with interest and the costs of collection.

Over the debtor's objection, the bankruptcy court sided with the creditor by holding that the remaining debt under the settlement agreement, some $230,000, was nondischargeable as a debt for willful and malicious injury. However, the bankruptcy court ruled that collection costs and interest were dischargeable as new debts.

The district court affirmed the ruling on the $230,000 in principal debt but reversed on interest and collection costs, declaring them also to be nondischargeable.

## Settlement Agreements Are Nondischargeable

The debtor appealed but lost across the board in a January 18 opinion by Circuit Judge Pamela Harris.

Section 523(a)(6), the governing statute, provides that "any debt" is nondischargeable "for willful and malicious injury by the debtor to another entity or to the property of another entity."


On appeal, the debtor conceded that his actions gave rise to a debt for willful and malicious injury, but he contended that the debt under the settlement agreement was a dischargeable debt arising from breach of contract.

In an understatement, Judge Harris said that the Supreme Court had given "important guidance" in *Cohen v. de la Cruz*, 523 U.S. 213, 223 (1998), and *Archer v. Warner*, 538 U.S. 314 (2003).

Referring to *Cohen*, Judge Harris recounted how the Supreme Court had said that the words "any debt . . . for" in Section 523(a) "'connote broadly any liability arising from the specified' conduct. *See Cohen*, 523 U.S. at 220."

In *Archer*, Judge Harris said that the Supreme Court rejected an argument that was "nearly identical" to the debtor's. In *Archer*, she said that the Supreme Court held that a settlement agreement arising from money obtained by fraud was nondischargeable under Section 523(a)(2)(A).

Judge Harris said that "*Archer* governs here." Parroting *Archer*, she held:

> [The debtor's] non-dischargeable debt for "willful and malicious injury" may have been reduced to a settlement agreement, but that does not "change[] the nature of the debt for dischargeability purposes."

*Archer*, *supra*, 538 U.S. at 320.

Interest and Collection Costs Are Also Nondischargeable

Having ruled that the unpaid principal debt of $230,000 under the settlement agreement was nondischargeable, Judge Harris turned to the dischargeability of interest and collection costs.

The debtor contended that the creditor's attorneys' fees in collecting the settlement and in contesting the bankruptcy were dischargeable because they did not arise directly from the assaults but came into being years later. Judge Harris disagreed, saying, "*Cohen* points toward the opposite result."

Judge Harris read *Cohen* as holding "that § 523(a)'s exceptions may reach punitive and other related ancillary debts." Thus, she concluded that "any debt" arising from the injury is nondischargeable, not just "the part of the debt that makes the victim whole."

Similarly, Judge Harris said that *Archer* "makes clear" that "a settlement agreement does not disrupt the causal chain." Consequently, she said that "collection debts, which 'flow directly from


[the] agreement for the express purpose of enforcing its terms' . . . remain 'traceable to' . . . the injury he inflicted on [the debtor]." [Citations omitted.]

Siding with decisions from the Seventh and Eighth Circuits, Judge Harris held that "interest on late payments and attorney's fees incurred in enforcing the agreement and contesting [the debtor's] bankruptcy proceedings" arise from willful and malicious injury and are nondischargeable.

The opinion is *Hilgartner v. Yagi (In re Hilgartner)*, 22-1762 (4th Cir. Jan. 18, 2024).


***The BAPCPA amendments in 2005 did not abrogate the absolute priority rule for individuals in chapter 11, Bankruptcy Judge Russin says.***

# The Absolute Priority Rule Is Alive and Well in Individual Chapter 11 Cases

Bankruptcy Judge Peter D. Russin of Fort Lauderdale, Fla., predicted that the Eleventh Circuit would follow five other circuits by holding that the amendment to Section 1129(b)(2)(B)(ii) in 2005 did not abrogate the absolute priority rule for an individual in chapter 11.

In his elegant opinion on September 8, Judge Russin took sides on another issue where the lower courts are divided by following a nonprecedential opinion from the Ninth Circuit and holding that the absolute priority rule does not preclude an individual chapter 11 debtor from retaining exempt property.

The Debts and the Plan

The individual debtor in chapter 11 owned a home and a truck that were both exempt. The debtor also owned two watches and about $12,000 in cash that were not exempt. Unsecured creditors had more than $750,000 in claims.

The debtor's chapter 11 plan committed to pay $30,000 to unsecured creditors over five years, for a dividend of about 4% to unsecured creditors.

Two classes of secured creditors accepted the plan. The unsecured creditor class voted "no," compelling the debtor to pursue confirmation of a so-called cramdown plan under Section 1129(b)(2)(B)(ii).

As amended in 2005 by the so-called BAPCPA amendments, Section 1129(b)(2)(B)(ii) provides that the "fair and equitable" requirement for classes of unsecured creditors means that "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115* . . . ." [Emphasis added.]

Also added among the BAPCPA amendments in 2005, Section 1115(a) provides that property of the estate for an individual in chapter 11


> includes, in addition to the property specified in section 541 — (1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first; and (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12, or 13, whichever occurs first.

Judge Russin confronted the question of whether the 2005 amendments excepted all estate property from the absolute priority rule or only property of the estate that was added by Section 1115, namely, property acquired after filing and postpetition earnings from services.

Judge Russin's Analysis

Judge Russin's opinion merits reading in full text for his explication of the history of the absolute priority rule. Currently, he said there is "a split of authority over what Congress meant by" the phrase "retain property included in the estate under section 1115."

Among lower courts, Judge Russin cited decisions taking the "broad view" that "an individual chapter 11 debtor can retain — without paying unsecured creditors in full — *all* property of the estate, whether it is acquired prepetition or postpetition." [Emphasis in original.]

The "narrow view," Judge Russin said, is that Congress only intended "to allow an individual debtor to retain the property that § 1115 added [*i.e.*, after-acquired property and earnings after filing], not the rest of the estate's property."

Judge Russin stated that the question was whether "Congress effectively abrogated the absolute priority rule in individual chapter 11 cases."

Although the Eleventh Circuit has not staked out a position, Judge Russin said that the Fourth, Fifth, Sixth, Ninth and Tenth Circuits have adopted the narrow view. He likewise adopted the narrow view, believing that the word "included" exempts after-acquired property and postpetition earnings from the absolute priority rule. Like the Fifth Circuit, he said that a broader reading would be "a stretch."

Judge Russin therefore held that "the absolute priority rule continues to apply in individual chapter 11 cases."

What About Exempt Assets?

Having decided that the absolute priority rule is alive and well, Judge Russin turned to the question of whether it precludes retention of both nonexempt and exempt property. He said that


"courts are unanimous that individual debtors violate the absolute priority rule if they receive or retain *non-exempt* property, [but are] are split over whether they violate the absolute priority rule if they receive or retain *exempt* property." [Emphasis in original.]

Judge Russin decided that the debtor would not violate the absolute priority rule by retaining exempt property, because the debtor would not be retaining the property "under the plan," the proscription in Section 1129(b)(2)(B)(ii).

Instead, Judge Russin said that the debtor would be retaining exempt property under Section 522, not under the plan. He therefore held that Section 1129(b)'s "specific reference to property retained 'under the plan' limits the absolute priority rule's prohibition to property of the estate, which simply does not include exempt property."

Judge Russin followed the Ninth Circuit, which held in 2020 that the absolute priority rule does not prohibit an individual debtor in chapter 11 from retaining exempt property. *In re Juarez*, 836 F. App'x 557, 561 (9th Cir. 2020).

Given his belief that the statute was "plain and unambiguous," Judge Russin held that "an individual chapter 11 debtor does not violate the absolute priority rule by receiving or retaining exempt property."

The Holding and the Implications for the Debtor

Judge Russin held that while "the absolute priority rule continues to apply in individual chapter 11 cases, it does not preclude debtors from retaining exempt property, but it does preclude them from retaining non-exempt property other than property described in § 1115."

Applying the holding to the case before him, Judge Russin said that the debtor could retain the exempt home and the exempt truck without violating the absolute priority rule. On the other hand, he declined to confirm the plan because the absolute priority rule precluded the debtor from retaining the two nonexempt watches and $12,000 in nonexempt cash.

Suggesting that his opinion was largely a victory for the debtor, Judge Russin allowed the debtor to amend the plan and "seek confirmation, possibly without having to resolicit."

Evidently, the debtor can "borrow" the $12,000 from creditors by paying $12,000 over five years without interest. That's a good deal!

The opinion is *In re Joseffy*, 21-19419 (Bankr. S.D. Fla. Sept. 8, 2023).


***Consolidating student loans after filing creates a post-petition debt that can't be discharged without filing bankruptcy again.***

# Student Loans Consolidated After Filing Can't Be Discharged, Even for Undue Hardship

Student loans consolidated after filing cannot be discharged even on a showing of "undue hardship," for reasons explained by Bankruptcy Judge Shad M. Robinson of Austin, Texas.

The debtor filed a chapter 7 petition with a passel of student loans totaling more than $480,000. Within three months, the debtor received his general discharge, and the case soon closed. Of course, the student loans were not discharged.

More than three years after discharge, the debtor consolidated the student loans with the same lender. Four years after discharge, the debtor reopened his case and filed an adversary proceeding to discharge the consolidated student loans for allegedly being an "undue hardship" under Section 523(a)(8).

In his September 26 opinion, Judge Robinson noted that the consolidated loan "extinguished and paid off" the student loans that had been outstanding when the debtor filed his chapter 7 petition.

The lender filed a motion for summary judgment to dismiss the adversary proceeding, contending that the consolidated loan was a post-petition obligation that the debtor could not discharge. Judge Robinson agreed.

Addressing the merits, Judge Robinson first cited Section 727(b), which says that a discharge "discharges the debtor from all debts *that arose before the date of the order for relief* under this chapter." [Emphasis added.] He held that "the proceeds of the Consolidation Loans did not arise *before* the date of the order for relief as required by 11 U.S.C. § 727(b)," because "the Consolidation Loans were new and distinct postpetition debts." [Emphasis in original.]

Judge Robinson buttressed his conclusion by referencing applicable regulations. One says that existing student loans are "discharged" when a consolidated loan is granted. Another regulation requires the new lender to notify the borrower that the prior loan was paid in full.

Judge Robinson granted the lender's motion for summary judgment dismissing the adversary proceeding. He held that "the Consolidation Loans are postpetition debts that are nondischargeable


as a matter of law under 11 U.S.C. § 727(b).” He thus never reached the question of whether the consolidated loan represented “undue hardship.”

In a footnote, Judge Robinson rejected the debtor’s contention that the consolidated loan should be considered a pre-petition debt because the pre- and post-petition lender was the same institution. He said that a consolidated loan “is a new debt, even if the lender remains the same.”

The opinion is *Hayward v. U.S. Dept. of Education (In re Hayward)*, 23-01004 (Bankr. W.D. Tex. Sept. 26, 2023).


# *Dismissal*


***Two judges on the Sixth Circuit cast doubt on the validity of the doctrine of equitable mootness, even in chapter 11 reorganizations.***

# Sixth Circuit Staunches the Spread of Equitable Mootness to Chapter 7

Declining "the request to expand broadly an already questionable doctrine," the majority on a Sixth Circuit panel held "that the doctrine of equitable mootness has no place in Chapter 7 liquidations."

Short of a categorical holding, the language in the majority's opinion by Circuit Judge Karen Nelson Moore has enough daylight to apply equitable mootness in an extraordinary chapter 7 case, perhaps on appeal from a highly complex settlement with hundreds of creditors who benefit from the settlement but are not before the appeals court.

Concurring in the judgment, Circuit Judge John B. Nalbandian would have ruled that the requirements of equitable mootness would not have been satisfied, even were the doctrine suitable for chapter 7. His opinion suggests that prior Sixth Circuit precedent would not have foreclosed the use of equitable mootness in chapter 7.

## Complex Appeal – Simple Facts

Missteps by the creditor in the bankruptcy court and the district court's misapprehension of the operative notice of appeal resulted in a procedural hash once the case reached the Sixth Circuit. For discussion of equitable mootness, the operative facts are simple.

The bankruptcy court granted a final allowance of compensation to a chapter 7 trustee. In the absence of a stay pending appeal, the trustee distributed the allowance to the trustee, and the bankruptcy court closed the case. The creditor appealed the closing of the case and the grant of compensation.

The district court dismissed the appeal on the grounds of both constitutional and equitable mootness. All three circuit judges agreed that the appeal was not constitutionally moot.

## Constitutional Mootness


The district court found the appeal constitutionally moot for lack of a stay pending appeal. Writing for all three judges, Judge Nalbandian said, "Failing to seek a stay does not render an issue constitutionally moot," because cases are reopened routinely.

Even absent a stay, Judge Nalbandian said that the bankruptcy court could have reopened the case and reconsidered the grant of compensation. Because the district court could have granted "effective relief," the appeal was not constitutionally moot.

Equitable Mootness

For the majority, Judge Moore defined the question on appeal as "whether a court of review can decline to consider the merits and bar the appeal of an order issued in a Chapter 7 liquidation bankruptcy."

Judge Moore said that equitable mootness does not flow from Article III standing principles but instead is a prudential doctrine. The three factors leading to a finding of equitable mootness are the lack of a stay pending appeal, substantial consummation and the effect on parties not before the court on appeal.

Equitable mootness first appeared in the Ninth Circuit in 1981 and later in the Seventh Circuit, Judge Moore said. The focus, she said, "remained on reorganization plans."

The Sixth Circuit first applied equitable mootness in 1995. In the succeeding 20 years, Judge Moore said that Sixth Circuit "continued to apply equitable mootness to bar appeals only of confirmation orders of reorganization plans in Chapter 11 reorganizations." In 2005 and 2008, she said that her appeals court again invoked the doctrine in chapter 11 reorganizations.

In Detroit's municipal debt-adjustment in 2016, Judge Moore said that the Sixth Circuit applied the doctrine "specifically because of the complex nature of the reorganization before the panel." She said there are "plenty of other courts and scholars" who say "that the complexity of the reorganization is a central tenet of the equitable-mootness doctrine."

Judge Moore described equitable mootness as invoking "third-party reliance interests" and serving as a tool to ensure success of the reorganization.

"[I]n every instance in which this court has contemplated applying equitable mootness to bar review of the merits of an appeal," Judge Moore said that "this court has remained committed to applying it narrowly — only contemplating barring appeals of confirmation orders of reorganization plans and inquiring into the complexity of the plan."


"[T]hese concerns and rationales are not implicated in Chapter 7 liquidations," Judge Moore said, because chapter 7 deals with simple liquidations where " 'there are rarely intricate transactions that need to be unraveled,' " quoting a commentator.

Observing that "no other circuit court has affirmatively embraced the equitable-mootness doctrine in Chapter 7 liquidations," Judge Moore reversed and remanded with instructions for the district court to consider the merits of the appeal.

The Concurrence

Concurring in the judgment, Judge Nalbandian saw no reason to ban equitable mootness from chapter 7 cases because, even if applied, "the claim would not be equitably moot."

Judge Nalbandian said that the Sixth Circuit had not ruled on the applicability of the doctrine in chapter 7. Contrary to the interpretation of the appeals court's precedents by the majority, he referred to the finding of equitable mootness in Detroit's municipal bankruptcy as showing "our circuit's momentum is moving in favor of equitable mootness's broad application."

"[A]ny reversal of a Chapter 7 liquidation," Judge Nalbandian said, "would likely be less difficult than the undoing of a Chapter 9 or 11 plan from the get-go."

Even if applicable, equitable mootness would not kill the appeal, in Judge Nalbandian's view, because "only professional fees are in dispute." In the event of reversal, other creditors would benefit by returning more to the estate for distribution to creditors generally.

Like the majority, Judge Nalbandian would reverse and remand to consider the merits of the appeal from the grant of compensation.

The opinion is *Taleb v. Miller Canfield Paddock & Stone PLC (In re Kramer)*, 20-2273 (6th Cir. June 16, 2023).


# *Plans & Confirmation*


***The Ninth Circuit BAP says that a later valuation can make a debtor eligible for chapter 13 when the original schedules meant ineligibility.***

# '13' Debtors May Bifurcate Mortgages that Mature Before the Final Plan Payment

When a home mortgage matures before the final payment under a chapter 13 plan, the debtor may bifurcate the mortgage into a secured and an unsecured claim, only paying the secured claim in full, the Ninth Circuit Bankruptcy Appellate Panel tells us.

The BAP's November 13 opinion has another interesting holding: When the schedules show that the debtor was ineligible for chapter 13 by having too much unsecured debt, the court's later valuation of the collateral could make the debtor eligible if the valuation decreases the amount of unsecured debt.

The First and Second Mortgages

The debtors filed a chapter 11 plan, scheduling their home as being worth about $1 million. They scheduled a first mortgage for approximately $950,000 and a second mortgage for some $465,000.

The second mortgage would mature before the end of the term of the plan. The debtors intended to bifurcate the second mortgage into an unsecured claim of about $375,000 and a secured claim of more than $90,000.

In his opinion for the BAP, Bankruptcy Judge Robert J. Faris said that the junior lender didn't realize until the debtors were into their fourth amended plan that the debtors were ineligible for chapter 13 because they had more unsecured debt than Section 109(e) allowed at the time. By then, however, the bankruptcy judge had held a valuation hearing and determined that the home was actually worth more than $1.2 million.

Consequently, the debtors amended the plan to bifurcate the second mortgage into a secured claim of $265,500 and an unsecured claim of something over $200,000. The lower unsecured claim on the mortgage would put the debtors below the Section 109(e) cap for unsecured claims.

Primarily, though, the junior lender objected to confirmation by contending that the debtors were obligated to pay the second mortgage in full, given the antimodification provision in Section 1322(b)(2).


The bankruptcy court overruled the objection and confirmed the plan. The junior lender appealed to the BAP.

The Exception in Section 1322(c)(2)

Section 1322(b)(2) allows a chapter 13 plan to "modify the rights of holders of secured claims, *other than a claim secured only by a security interest in real property that is the debtor's principal residence*." [Emphasis added.] But there is an exception. When the last payment on a home mortgage is due before the last payment on the plan, Section 1322(c)(2) allows the plan to "provide for the payment of the claim as modified."

Judge Faris described the junior lender as arguing that "the statute allows for modification of only the payment term, not the claim itself."

The lender relied on *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), where the Supreme Court held that Section 1322(b)(2) would not permit bifurcation. Judge Faris said that reliance on *Nobelman* "fails" because Congress amended the Code a year later by adding Section 1322(c)(2).

Although the Ninth Circuit has not ruled on the permissibility of bifurcation under Section 1322(c)(2), Judge Faris cited the Fourth and Eleventh Circuits, along with other courts that permit bifurcation of a mortgage that matures before the plan's end.

In league with the "overwhelming weight of authority," Judge Faris said that Section 1322(c)(2) was not ambiguous and that it "allows modification" of the junior lender's claim. The "only reasonable way to read the statute," he said, is to say that the antimodification language in subsection (b)(2) "does not have any application" to claims that fall under subsection (c)(2).

Furthermore, Judge Faris observed that Congress "would have said so" if it "intended to require full payment in Section 1322(c)(2)." He found no error in the bankruptcy court's ruling that the plan could modify the junior mortgage.

Chapter 13 Eligibility

Judge Faris addressed the lender's belated objection to eligibility for chapter 13. He recognized that the Ninth Circuit had held that "eligibility should *normally* be determined by the debtor's originally filed schedules, checking only to see if the schedules were made in good faith." *Scovis v. Henrichsen (In re Scovis)*, 249 F.3d 975, 982 (9th Cir. 2001). [Emphasis added.]

If the debtor's original schedules were the end of the story, Judge Faris would have set aside confirmation and dismissed the case, because the original schedules were filed in good faith and


showed that the debtors had too much unsecured debt, as Section 109 was written at the time. However, he latched on to the word "normally" in *Scovis* to conclude that the debtors were eligible once the bankruptcy court valued the home.

Judge Faris said it was not a "normal" case. "In most cases," he said, "eligibility is raised early in the case." In the case on appeal, the lender did not raise eligibility until after the bankruptcy court had valued the property. After valuation, he said "it would be absurd to require the court to consider only the earlier-filed schedules and disregard its own finding of value."

Judge Faris upheld confirmation of the plan, finding no error in the bankruptcy court's conclusion that the debtors were eligible for chapter 13.

The opinion is *Mission Hen LLC v. Lee (In re Lee)*, 22-1250 (B.A.P. 9th Cir. Nov. 13, 2023).


***Courts are split on whether the confirmation requirements in Section 1325(b)(1) apply when a debtor seeks confirmation of an amended plan.***

# Section 1325(b)(1) Held Applicable to Post-Confirmation Amendments to Chapter 13 Plans

When there is an objection to confirmation, Section 1325(b)(1) requires the debtor to pay creditors in full or devote all "projected disposable income" to the payment of claims.

On a question where courts are divided, Bankruptcy Judge Laura K. Grandy of East St. Louis, Ill., decided that the section applies when a debtor is seeking confirmation of a post-confirmation, amended plan.

100% Plan: Now You See It, Now You Don't

The below-median-income debtor confirmed a plan with 100% for unsecured creditors. Although the debtor could have used a 36-month plan, she elected to have a 60-month plan where her monthly payment would be $600, or less than half of her projected disposable income of almost $1,300 a month.

Over objection, Judge Grandy confirmed the plan because the debtor was promising to pay 100%, putting the plan under one of the alternatives in Section 1325(b)(1). The section provides:

> If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan —
>
> (A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
>
> (B) the plan provides that all of the debtor's projected disposable income to be received in the applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.

The debtor's income fluctuated after confirmation, but she did not report the changes to the court. Evidently, she was mostly able to keep up with plan payments because her income was still enough given that she was paying less than half of her projected disposable income.


In the third year of the plan, the debtor retired. Her income fell by more than half. At that point, she filed amended Schedules I and J and sought confirmation of an amended plan to pay about $100 a month, this time with nothing for unsecured creditors.

The debtor contended that the plan was confirmable because her disposable income after retirement was negative by $400 a month. The trustees objected to confirmation, contending that the debtor was not complying with Section 1325(b)(1).

In her April 1 opinion, Judge Grandy sustained the trustee's objection to confirmation of the amended plan.

Why Section 1325(b)(1) Applies

To resolve the confirmation objection, the other applicable statute was Section 1329, titled "Modification of a plan after confirmation." Subsection (b) provides:

> (1) Sections 1322(a), 1322(b), and 1323(c) of this title and the requirements of section 1325(a) of this title apply to any modification under subsection (a) of this section.
> (2) The plan as modified becomes the plan unless, after notice and a hearing, such modification is disapproved.

Notably, Section 1325(b)(1) is not listed among the sections that apply to post-confirmation plan modifications. Judge Grandy therefore said that courts "are split on the issue of whether § 1325(b) applies to post-confirmation plan modifications under § 1329(b)."

Other courts, Judge Grandy said, "have held that § 1325(b) *does* apply to modifications, because the preface of § 1325(a) cross-references § 1325(b)." [Emphasis in original.]

Judge Grandy found practical reasons for making Section 1325(b) applicable:

> Failure to apply § 1325(b) requirements to plan modifications would invite abuses of the modification process. Debtors could simply attempt an end around of § 1325(b)'s requirements by confirming a plan that complied with § 1325(b), then modifying that plan to avoid further compliance with that section. This approach would render the disposable income test and applicable commitment periods a fleeting nullity.

Having decided that 1325(b) applies, Judge Grandy applied the law to the facts.

Before the debtor's income declined in the first year after confirmation, Judge Grandy calculated that the debtor had almost $4,900 in excess disposable income, enough to have paid her


$4,500 in unsecured claims in full. Over the three years of the plan, she calculated that "the Debtor had more than adequate funds to pay her allowed unsecured claims in full."

Holding "that plan modifications are subject to the requirements of 11 U.S.C. § 1325(b)," Judge Grandy sustained the objection to confirmation of the amended plan, because the "Debtor in this case unquestionably failed to pay in all of her disposable income over the duration of the plan, and is now proposing a plan that pays less than 100% of allowed general unsecured claims."

The opinion is *In re Halwachs*, 19-30557 (Bankr. S.D. Ill. April 1, 2024).


***A chapter 7 trustee's obligation to sell can mean that chapter 7 prices don't fit the ordinary definition of fair market value.***

# Judge Faris Explains Why a Hypothetical Chapter 7 Sale Isn't Necessarily 'FMV'

An opinion by Bankruptcy Judge Robert J. Faris explains why the valuation of a debtor's assets in a chapter 11 cramdown can be lower than "fair market value" in an ordinary appraisal, because a hypothetical chapter 7 trustee is typically compelled to sell expeditiously without the luxury of operating the business.

Sitting in Honolulu, Judge Faris composed a template for someone writing a cramdown opinion where the focus is valuation. Judge Faris also sits on the Ninth Circuit Bankruptcy Appellate Panel.

The Decrepit Dairy Farm

The corporate debtor in Subchapter V of chapter 11 operated a dairy farm with a herd of 1,100 dairy cattle. The business operated on land leased from the State of Hawaii under a seven-year lease where several years had already burned off.

In his October 24 opinion, Judge Faris said that the "facilities and equipment are outdated and in dilapidated condition" and that the cattle were mostly "in poor to fair condition" with "less genetic diversity than is desirable."

Three years before bankruptcy, the debtor contracted to sell the business for $700,000, but the buyer never closed. Also before bankruptcy, a third party purchased most of the debtor's stock for $600,000 and provided another $450,000 in financial support.

In chapter 11, the new owner supplied $200,000 in so-called DIP financing approved by Judge Faris. The debtor was losing about $90,000 a month in chapter 11, the judge said.

The debtor proposed a chapter 11 plan with nothing for unsecured creditors. Judge Faris explained that secured and priority claims totaled more than $1.4 million, with administrative claims adding another $800,000.

Before unsecured creditors would be entitled to a distribution in the plan, Judge Faris said that "all secured, administrative, and priority claims would have to be paid in full," a total of some $2.2 million.


Receiving nothing under the plan, unsecured creditors were deemed to have rejected the plan. For a so-called cramdown under Sections 1191 and 1129, Judge Faris said that all of the requirements had been met aside from the "best interests" test, as defined in Section 1129(a)(7)(A)(i). To confirm over a dissenting class, the section requires the debtor to prove that unsecured creditors will receive "not less than the amount that [unsecured creditors] would so receive or retain if the debtor were liquidated under chapter 7 of this title."

The Hypothetical Sale

Before valuing the debtor's assets, Judge Faris pointed out the implications of a hypothetical sale by a chapter 7 trustee.

Quoting Bankruptcy Judge Christopher M. Klein, Judge Faris said that a "hypothetical liquidation 'entails a considerable degree of speculation about a situation that will not occur unless the case is actually converted to chapter 7.'" *In re Sierra-Cal*, 210 B.R. 168, 172 (Bankr. E.D. Cal. 1997). Next quoting a district judge from New York, he said that a hypothetical chapter 7 sale price is "inherently speculative."

Paraphrasing the *Collier* treatise, Judge Faris said that "chapter 7 trustees often must sell property for less than the amount that a private, solvent seller could realize." He proceeded to explain why a chapter 7 sale won't bring the best price.

First, a trustee must sell quickly, "although not necessarily at 'fire sale' prices." If a sale is "impossible or disadvantageous," the trustee must abandon the property.

If the property were in the hands of a private party, the owner could continue operating while searching for a better offer. On the other hand, Judge Faris said that a chapter 7 trustee "rarely" seeks and obtains court approval to operate the business and would probably need financing, another factor requiring court approval.

In short, a chapter 7 trustee is under pressure to sell.

The Facts Applied to the Law

Alluding to the $700,000 sale that never closed, Judge Faris decided that $700,000 was the best price that a trustee could obtain for all of the assets, including the dairy cattle and the lease. He said it was "nearly inconceivable" that the value had risen in the last three years.

Judge Faris rejected the idea of selling the cattle on the mainland, because transportation costs of $560,000 needed to be paid up front, but the trustee had less than $70,000 in cash.


The creditor's expert claimed that the lease alone was worth $1.15 million. Judge Faris disagreed, for several reasons.

Primarily, Judge Faris said that the expert's valuation of the lease, based on projected cash flow, "represents the appraiser's opinion of the 'market value' of the leasehold, 'assuming that neither [the buyer nor the seller] is under undue duress.'"

"As I have explained above," Judge Faris said, "the law basically forces a chapter 7 trustee to sell quickly. A definition of market value that assumes no 'undue duress' is not a good fit."

The unsecured creditors' expert believed that the lease was worth $1 million just to grow hay for someone else.

First, the lease only allowed growing hay for use on the ranch itself. Second, the terrain was "too rough" for harvest. Consequently, Judge Faris concluded that "the grass on the ranch is probably valuable only to the lessee under the lease."

The Numbers Don't Work for Unsecured Creditors

A chapter 7 trustee must sell the assets for more than $2.2 million before unsecured creditors would be entitled to a distribution.

Even if the lease itself were worth $1 million and a trustee could sell other assets for $700,000, Judge Faris said that "unsecured creditors would still receive nothing."

Judge Faris overruled the objection to confirmation and directed the debtor's counsel to submit a confirmation order.

The opinion is *In re Boteilho Hawaii Enterprises Inc.*, 22-00827 (Bankr. D. Haw. Oct. 24, 2023).


# *Compensation*


***The same question has been sub judice in the Second Circuit for 15 months. Is the Second Circuit on the cusp of making a circuit split?***

# Three Circuits Now Say '13' Trustees Aren't Paid if Dismissal Precedes Confirmation

Three circuits now hold that chapter 13 trustees are *not* paid their fees when cases are dismissed before confirmation. In an opinion on March 3, the Seventh Circuit joined the Ninth and Tenth Circuits. In February, the Supreme Court denied *certiorari* in the cases from the Ninth and Tenth Circuits.

The possibility of a circuit split remains because the identical issue was argued in the Second Circuit on February 15, 2023. In the case before the Second Circuit, both the bankruptcy court and the district court held that the chapter 13 trustee was entitled to payment despite dismissal before confirmation.

In the case on direct appeal to the Seventh Circuit, the chapter 13 debtor had made plan payments of $3,800 to the chapter 13 trustee. The debtor never confirmed a plan, and the case was dismissed. Before confirmation, the chapter 13 trustee had made $750 in adequate protection payments to a secured creditor. The trustee had also deducted $260 as compensation under 28 U.S.C. § 586(e)(2).

After dismissal, the trustee sent the debtor the $3,800 less the $750 and the $260. The debtor filed a motion asking the bankruptcy court to direct the chapter 13 trustee to disgorge the trustee's fee by turning the $260 over to the debtor. Bankruptcy Judge Timothy A. Barnes of Chicago granted the motion and directed the trustee to turn over the fees to the debtor. *See In re Johnson*, 650 B.R. 904 (Bankr. N.D. Ill. May 12, 2023). To read ABI's report, click here.

The Seventh Circuit accepted a direct appeal and affirmed in a May 3 opinion by Circuit Judge Thomas L. Kirsch, II.

In the first paragraph of his six-page opinion, Judge Kirsch said, "we agree with the Ninth and Tenth Circuits that the United States Bankruptcy Code requires the Chapter 13 trustee to return her fee when the debtor's plan is not confirmed." He found the answer in the words of the statutes, 28 U.S.C. § 586(e)(2) and Section 1326(a)(2) of the Bankruptcy Code.


"If a plan is not confirmed," Section 1326(a)(2) says that "the trustee shall return any such payments not previously paid and not yet due and owing to creditors . . . to the debtor, after deducting any unpaid [administrative] claim allowed under section 503(b)."

Section 586(e)(2) provides that a chapter 13 trustee "shall collect such percentage fee from all payments received by such individual under plans in the cases under . . . chapter . . . 13 of title 11."

Quoting the Tenth Circuit, Judge Kirsch said that Section 1326(a)(2) "requires 'the standing trustee [to] return all of the pre-confirmation payments [she] receives, without first deducting [her] fee.' *In re Doll*, 57 F.4th 1129, 1141 (10th Cir. 2023) (emphasis in original)."

There are two exceptions in the subsection, but neither one applies, Judge Kirsch said. First, the chapter 13 trustee's fee is not an administrative expense. Second, the trustee's fee was not "previously paid," because "only certain adequate protection payments are permitted pre-confirmation." Likewise, he said that the trustee fee is not "a payment 'due and owing to creditors.'"

"Because neither exception applies to the Chapter 13 trustee's fee," Judge Kirsch held that the trustee "must return her fee to the debtor."

Judge Kirsch rejected the trustee's arguments based on other provisions in Section 1326(b). "Before or at the time of each payment to creditors under the plan," the subsection provides that "there shall be paid — (1) any unpaid claim of the kind specified in section 507(a)(2) of this title; (2) if a standing trustee appointed under section 586(b) of title 28 is serving in the case, the percentage fee fixed for such standing trustee under section 586(e)(1)(B) of title 28."

Because a plan was never confirmed, Judge Kirsch said that "§ 1326(b) is inapplicable." He likewise said that "the trustee also has no right to keep her fee under 28 U.S.C. § 586(e)(2), which states that the trustee 'shall collect such percentage fee from all payments received by such individual under plans . . . .'"

Judge Kirsch said that "§ 586(e)(2) is irrelevant, as it 'only addresses the source of funds that may be accessed to pay standing trustee fees.' *In re Doll*, 57 F.4th at 1140."

Judge Kirsch buttressed his conclusion by allusion to the "treatment of the trustee's fee in . . . cases brought under Chapter 12 and Subchapter V of Chapter 11." In both instances, he quoted the Tenth Circuit for saying that "'Congress provided explicitly that the standing trustee should first deduct his or her fee before returning pre-confirmation payments to the debtor.' *Id.* at 1141 (emphasis in original)."

Joining the Ninth and Tenth Circuits, Judge Kirsch held "that the Chapter 13 trustee must return her fee when, as here, the debtor's plan is not confirmed."


Other Authorities

The opinion from the Ninth Circuit disallowing a chapter 13 trustee's fees if dismissal precedes confirmation is *Evans v. McCallister (In re Evans)*, 69 F.4th 1101 (9th Cir. June 12, 2023) (*cert. den.* Feb. 20, 2024). To read ABI's report, click here. To read ABI's report on *Doll* from the Tenth Circuit, click here. The Supreme Court denied *certiorari* in *Doll* on Feb. 20, 2024.

There being no circuit split, the denial of *certiorari* in *Doll* and *Evans* was not surprising.

In the Eastern District of New York, Bankruptcy Judge Robert E. Grossman ruled that a chapter 13 trustee is entitled to compensation if the case is dismissed before confirmation. *See In re Soussis*, 624 B.R. 559 (Bankr. E.D.N.Y. Nov. 12, 2020). To read ABI's report, click here. Judge Grossman was affirmed in district court. *See Soussis v. Macco*, 20-05673, 2022 WL 203751 (E.D.N.Y. Jan. 24, 2022). To read ABI's report on the district court opinion in *Soussis*, click here.

*Soussis* remains *sub judice* in the Second Circuit, having been argued on Feb. 15, 2023. The Second Circuit was made aware of both *Doll* and *Evans*. One wonders whether the delay in issuing the opinion means that the Second Circuit is considering making a circuit split.

The opinion is *Marshall v. Johnson*, 23-2212 (7th Cir. May 3, 2024.)


***The Ninth and Tenth Circuit disallow fees to chapter 13 trustee if the case is dismissed before confirmation. The identical issue is sub judice in the Second Circuit.***

# Two Circuits Now Hold: '13' Trustees Aren't Paid if Cases Dismiss Before Confirmation

Joining the Tenth Circuit, the Ninth Circuit also has held that chapter 13 trustees are *not* paid their fees when cases are dismissed before confirmation. The identical issue was argued on February 15 before the Second Circuit.

In short order, we'll have either unanimity or a split of circuits. A split will give rise to an issue worthy of a grant of *certiorari* by the Supreme Court.

Notably, the Ninth Circuit's opinion on June 12 adopted reasoning in an *amicus* brief filed in support of the debtor by the National Consumer Bankruptcy Rights Center and National Association of Consumer Bankruptcy Attorneys.

Lower Court Rulings

A couple filed a chapter 13 petition. After dismissing the case voluntarily before confirmation, the debtors filed a motion asking the bankruptcy court to have the chapter 13 trustee disgorge the fees that she had retained.

Chief District Bankruptcy Judge Joseph M. Meier of Boise, Idaho, decided that the statutes were ambiguous and concluded that a chapter 13 trustee is paid only if a plan is confirmed. *See In re Evans*, 615 B.R. 290 (Bankr. D. Idaho Feb. 13, 2020). To read ABI's report, click here.

On appeal, the district court reversed, found no ambiguity in the statute, and held that "§ 1326(a)(2) does not direct the Trustee to return it if confirmation does not happen." *McCallister v. Evans*, 637 B.R. 144, 150 (D. Idaho Feb. 8, 2022). To read ABI's report, click here.

The debtors appealed to the Ninth Circuit.

The Relevant Statutes

The fees of chapter 13 trustees are not to be a burden on taxpayers nor on the budget of the U.S. courts. To be paid by chapter 13 debtors, the trustees' fees are determined by


the Attorney General under the criteria specified in 28 U.S.C. § 586(e)(1). Sometimes read in favor of paying trustees in all circumstances, 28 U.S.C. § 586(e)(2) says that a standing trustee "shall *collect* such percentage fee from all payments . . . under [chapter 13] plans . . . ." [Emphasis added.]

Debtors rely on Section 1326(a)(2) of the Bankruptcy Code, which 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)."

Section 1326 (a)(2) does not explicitly say what happens to a trustee's fees when the case is dismissed before confirmation.

The chapter 13 trustee relied on the definition of "collect" in *Black's Law Dictionary* to mean "receive payment." The debtor wanted the Ninth Circuit to read "collect" to mean "collect and hold."

In his decision for the Court of Appeals, Circuit Judge Milan D. Smith, Jr. said that the *amici* had the "better approach."

The Twomey Interpretation

Judge Smith paraphrased the *amici* for positing "that the phrase 'payments . . . under plans' in Section 586, when read in the larger context of the Bankruptcy Code, refers only to payments under *confirmed* plans, rendering the provision irrelevant to the *pre-confirmation* period." [Emphasis in original.] He retold how the *amici* said that "the place to look is instead Sections 1326(a) and (b)."

Proffering his own interpretation, Judge Smith said that "Section 1326(a)(1)(A) refers to payments '*proposed by* the plan,'" while Section 586 "refers to 'payments . . . under plans.'"

"Accordingly," Judge Smith said, "prior to confirmation, a trustee does not 'collect' or 'collect and hold' fees under Section 586, but instead 'retains' payments 'proposed by the plan' pursuant to Section 1326(a)(2)." If the plan is not confirmed, he said that "Section 1326(a) requires return of 'any such payments' . . . to the debtor, after deducting amounts previously paid and due and owing to creditors."

Saying that "[w]e generally agree with" the *amici*, Judge Smith read Section 1326(b) as indicating "that a standing trustee can be paid her percentage fee only after confirmation."

Holding that trustees are not paid if dismissal precedes confirmation, Judge Smith said that the "plain text of Section 1326(b) unambiguously shows that it is the specific provision governing


when a trustee 'shall be paid': 'before or at the time of each payment to creditors under the plan,' which necessarily means post-confirmation of a plan."

Further lauding the *amici's* reading of the statutes, Judge Smith said that their "interpretation is consistent with the opinion of the only other circuit to reach this issue," citing the Tenth Circuit in *Goodman v. Doll* (*In re Doll),* 57 F.4th 1129 (10th Cir. 2023). To read ABI's report on *Doll*, click here. [Note: The Tenth Circuit denied motions for rehearing and rehearing *en banc*, and also denied a motion to stay the issuance of the mandate pending a petition for *certiorari* to the Supreme Court. Time remains for the trustee to file a petition for *certiorari*.]

Other Theories

To assuage doubt about his interpretation of the statutes, Judge Smith pointed to chapter 12 and Subchapter V of chapter 11, which, he said, "have language almost identical to Section 1326(a), but explicitly mandate that fees be paid to trustees regardless of plan confirmation." Those statutes, he said, "show that Congress knew how to explicitly require payment of trustee fees in the event of non-confirmation . . . and suggest that it intentionally chose not to require the same in the Chapter 13 context."

With regard to policy, Judge Smith mentioned the trustee's contention that disallowing fees in dismissed cases would unfairly shift the burden onto debtors whose cases are not dismissed. However, he noted that the "policy was only changed recently." Trustees were first permitted to collect fees prior to confirmation in 2012 and weren't allowed to collect on receipt until 2014.

"Notably," Judge Smith referred to the Executive Office for the U.S. Trustee's *Handbook for Chapter 13 Standing Trustees*, which tells trustees to reverse payment only if there is controlling law in the district. He said that the "Trustee's policy arguments are not enough to overcome the plain language and context of the relevant statutory provisions, which indicate that standing trustees are only to be paid once a plan is confirmed."

Updates

In the Eastern District of New York, Bankruptcy Judge Robert E. Grossman ruled that a chapter 13 trustee is entitled to compensation if the case is dismissed before confirmation. *See In re Soussis*, 624 B.R. 559 (Bankr. E.D.N.Y. Nov. 12, 2020). To read ABI's report, click here. Judge Grossman was affirmed in district court. *See Soussis v. Macco*, 20-05673, 2022 WL 203751 (E.D.N.Y. Jan. 24, 2022). To read ABI's report on the district court opinion in *Soussis*, click here.

The debtor appealed. Oral argument was held in the Second Circuit on February 15. The debtor in *Soussis* immediately gave the Second Circuit a copy of the Ninth Circuit decision.


Recently, Bankruptcy Judge Timothy A. Barnes of Chicago denied compensation in a dismissed case and certified the question to the Seventh Circuit for direct appeal. *See In re Johnson*, 650 B.R. 904 (Bankr. N.D. Ill. May 12, 2023). To read ABI's report, click here. The Seventh Circuit has yet to accept or reject a direct appeal.

The opinion is *Evans v. McCallister (In re Evans)*, 22-35216 (9th Cir. June 12, 2023).


***Seemingly in conflict with Section 329, a district court decided that a chapter 7 debtor's attorneys could sue for post-petition fees, even though the firm never disclosed the fee arrangement as required by Section 329 and Rule 2016.***

# District Court Disregards the Bankruptcy Court's Authority over Post-Petition Fees

A troubling decision from a district court in New Jersey seems to have disregarded the power of a bankruptcy court under Section 329 to rule on the adequacy of disclosures and the amount of compensation paid to an attorney by a chapter 7 debtor for post-petition services.

As described in a March 30 opinion by District Judge Karen S. Williams of Camden, N.J., a couple hired a law firm to file what they said would be a simple, no-asset chapter 7 case in New Jersey. The firm charged the couple $6,500 plus the filing fee, she said.

Fee Litigation in Two Courts

According to Judge Williams, the firm "claims that it explicitly and repeatedly informed the [debtors] that they would be charged additional legal fees if their bankruptcy required any post-petition work." The case turned out to be difficult and turbulent as a consequence of what the firm claimed to be the debtors' lack of cooperation and concealment of assets.

Before the firm won permission to withdraw more than two years after filing, the firm ran up almost $230,000 in fees. Along the way, Judge Williams said that the debtors signed an agreement to pay the firm's fees from the sale of real property that was not an estate asset. According to the judge, the debtors sold the property but didn't pay the attorneys.

The opinion by Judge Williams does not describe any fee disclosures that the firm filed with the bankruptcy court under Rule 2016(b).

After withdrawal, the firm sued the debtors for fees in federal district court in Pennsylvania based on diversity of citizenship. The district judge in Pennsylvania denied the debtors' motion to dismiss for improper venue or to transfer the suit to New Jersey.

The debtors then filed a motion in the New Jersey bankruptcy court, asking the judge under Section 329 and Rule 2016 to determine the reasonableness of the firm's fees and whether or not there had been a proper fee agreement. The debtors also filed a motion in the Pennsylvania court


seeking a stay pending the outcome of the proceedings in bankruptcy court. The Pennsylvania district judge declined to stay the suit, saying that the firm was entitled to a jury trial.

Judge Williams described how the New Jersey bankruptcy judge did not pass on the reasonableness of the firm's fees but did decide "that the firm had failed to timely and accurately update its fee disclosure statements, thereby violating 11 U.S.C.§ 329 and Federal Rule of Bankruptcy Procedure 2016." She also said that the bankruptcy court did not rule on the firm's Seventh Amendment right to a jury trial.

As a sanction, Judge Williams said that the New Jersey bankruptcy court prohibited the firm from pursuing the suit in Pennsylvania and directed the firm to disgorge fees it had been paid by the debtors. The bankruptcy court granted a stay pending appeal, and the Pennsylvania court stayed the collection suit pending the outcome of the New Jersey appeal.

The Right to a Jury Trial Prevails

On appeal in New Jersey, the firm harped on the deprivation of its right to a jury trial.

Judge Williams said that a creditor loses the right to a jury trial by filing a proof of claim and that professionals forfeit jury trials by filing fee applications. However, she noted that the firm had filed neither a claim nor a fee application. She also said that lawyers "do not automatically forfeit their Seventh Amendment rights solely because they represented a debtor in a bankruptcy proceeding . . . particularly [when they] seek only to be compensated for post-petition legal services from outside of the bankruptcy estate."

Correctly, but incompletely, Judge Williams cited Rule 2016(a), which requires professionals to file fee applications when seeking compensation "from the estate."

Because the firm had filed neither a fee application nor a claim, Judge Williams said that the debtors could "take issue with the reasonableness of [the firm's] fees or the adequacy of its disclosures . . . in the Collection Action" in Pennsylvania. She reversed the bankruptcy court, holding that "the Seventh Amendment entitles [the firm] to have its claims heard and decided in the U.S. District Court for the Eastern District of Pennsylvania."

Observations

The decision by Judge Williams does not recite some of the findings and holdings by the bankruptcy court. For example, the bankruptcy court found that the firm failed to disclose under Rule 2016 that post-petition services were not covered by the fees that the debtors paid before filing. Indeed, the bankruptcy court found that the fees paid before filing included representing the debtors in "adversary proceedings and other contested matters."


Accordingly, the bankruptcy court found that the firm "failed to make the required disclosure under section 329 and Rule 2016. [The firm] did not disclose that any services in connection with the bankruptcy case were excluded from $3,500 paid."

The bankruptcy court held that the firm "violated the disclosure requirements of section 329 and Rule 2016(b)." As a sanction, the bankruptcy court ordered the disgorgement of the $3,500 fee listed on the Rule 2016(b) statement and said that the firm could only sue in Pennsylvania for fees "not incurred in connection with this bankruptcy case." To read the bankruptcy court's opinion, click here.

With respect, the district court seems not to have given effect to the authority of a bankruptcy court under Section 329(a). It provides:

> Any attorney representing a debtor in a case under this title, . . . whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.

The authority of a bankruptcy court with regard to the fees paid by a chapter 7 debtor does not end with the disclosures required by Section 329(a) and Rule 2016(b). Section 329(b) gives the bankruptcy court control over fees paid by a chapter 7 debtor for post-petition services. The subsection reads:

> If such compensation exceeds the reasonable value of any such services, the court may cancel any such agreement, or order the return of any such payment, to the extent excessive, to — . . . (2) the entity that made such payment.

In the case at hand, the bankruptcy court found violations of Rule 2016 and Section 329 in that the firm did not disclose that it would bill the client for post-petition services. The firm also did not disclose post-petition fee agreements with the debtors.

Unless Section 329 violates the Seventh Amendment, this writer believes that the bankruptcy court had the authority under Section 329 to rule on the "reasonable value" of the firm's fees, whether or not the firm filed a fee application.

To this writer, a professional who agrees to represent a chapter 7 debtor in view of the requirement of disclosure and the power of the bankruptcy court to determine the value of services under Section 329 has waived Seventh Amendment rights.

The foregoing opinions are those of this writer, not ABI.


The opinion is *Spector Gadon Rosen Vinci PC v. Aquilino (In re Aquilino)*, 23-01099 (D.N.J. March 30, 2024).


***The fee application by an attorney for a chapter 7 trustee in a small case must state facts to show why the services must have been performed by an attorney, not by the trustee.***

# BAP Lays Down Pleading Rules for Fee Applications in Small Chapter 7 Cases

The Ninth Circuit Bankruptcy Appellate Panel laid down rules about the sufficiency of pleadings and the burden of proof in small chapter 7 cases when the trustee seeks compensation for himself as his own attorney.

In short, the attorney's fee application must contain facts showing that the chores required the services of counsel. As the BAP said in its December 19 opinion, "blind insistence that [the time spent as an attorney] was compensable professional time because [the attorney-trustee] said so is not sufficient to satisfy the requirements of the Bankruptcy Code."

In a couple's chapter 7 case where filed claims were less than $10,000, the trustee obtained the court's authority to retain himself as his own trustee. At the end of the case, the attorney filed a final fee application seeking almost $3,400 for 11.3 hours of work at $300 per hour. The fee application listed 8.4 hours of time for "litigation." The remainder sought compensation for preparing the retention application and the fee application.

The U.S. Trustee objected to the fee application, primarily asserting that the attorney was seeking compensation for services ordinarily performed by a trustee. Bankruptcy Judge Scott H. Gan of Phoenix sustained the objection and granted only $870 in compensation. Judge Gan disallowed all of the compensation for litigation while allowing compensation for the preparation of the retention and fee applications.

The attorney appealed to the BAP, principally arguing that the party objecting to a fee application carries the burden of showing that the fees were unreasonable or unnecessary. The BAP disagreed and affirmed Judge Gan in a nonprecedential, unsigned, memorandum opinion.

The BAP panel said that a fee award will be upheld absent an abuse of discretion or an erroneous application of law. The panel said it uses an "extremely deferential standard" because the "bankruptcy court is uniquely in the best position to assess the amount of work done, its contribution to the administration of the estate, and its benefit to the stakeholders."


The panel bemoaned the difficulty in assessing fee allowances in small cases where "the court simply does not have the same opportunity to assess the nature of the work or whether it was actually necessary." In mid-sized and larger cases, the panel said that the "skill requisite to achieve those results may be much more obvious."

The panel agreed that the objecting party has the burden of proof to show that the fees were unreasonable or unnecessary but disagreed with the attorney's premise "that the burden of the objecting party somehow relieves the professional from its burden to establish that its requested fees are reasonable in the first instance."

In what amounts to a rule regarding the sufficiency of a pleading to state a claim for an award of fees, the panel said that the "burden is on the party requesting allowance of the fees to establish that the requirements of the Code have been met." In the case on appeal, the panel said that the attorney "failed to offer sufficient evidence that the fees were reasonable and necessary under the requirements of § 330(a)."

The panel explained why the fee application did not measure up in terms of stating facts sufficient allege a claim. The attorney-trustee said in a pleading in bankruptcy court that it was "his opinion" that the services were not those to be performed by a trustee. The panel rebutted the contention by saying that the fee application

> contained no separate declaration . . . that the services rendered were actually and necessarily performed within § 330. The single-sentence explanation in the application for the work is: "[t]hat the legal services rendered in this Case were required and benefitted the Estate including (but not limited to) the following: Legal work to prosecute and settle Litigation to recover the Bankruptcy Estate's interest in Estate Assets."

The "litigation" for which the attorney had sought fees included $2,500 recovered as a settlement with the debtors on account of $5,000 they had withdrawn from a bank account before bankruptcy. The attorney-trustee also negotiated for the estate to retain about $3,000 from the apportionment of a $9,400 tax refund the debtors received. The bankruptcy court approved both settlements based on terse applications.

The panel cited its own precedent by saying that an attorney "must therefore present sufficient evidence including billing records with enough detail to establish that the services rendered went beyond the scope of the trustee's statutory duties and involve unique difficulties." The BAP found "nothing in the record that would support a finding that the efforts disallowed by the bankruptcy court required expertise beyond that expected of an ordinary trustee."

Furthermore, the BAP said that an attorney must exercise "billing judgment" and that "[h]aving an attorney perform a task does not compel a finding that the fees were necessary *per se*." The


panel said it "implicitly" relies "on the trustee to exercise appropriate discretion before burdening the estate, and in particular a small estate, with attorney's fees where the task might well have been performed by the trustee."

In conclusion, the BAP said that the attorney "offered no explanation as to why litigation was required to monetize what was obviously going to be a simple and nominal recovery for the estate." Affirming the bankruptcy court, the panel said that the attorney "offered no evidence that he considered the potential for recovery and did any balancing assessment before filing the turnover motion."

The opinion is *Smith v. U.S. Trustee (In re Rivera)*, 23-1047 (B.A.P. 9th Cir. Dec. 19, 2023).


# *Estate Property*


***Now a circuit judge, a former bankruptcy judge makes quick work of a troublesome issue about property of the estate.***

# Eighth Circuit Definitively Holds: Avoidance Actions Are Estate Property and Can Be Sold

The Eighth Circuit has held definitively that avoidance actions are property of the estate under Section 541(a) that a trustee may sell "free and clear."

The tightly written opinion on August 21 by Circuit Judge Michael J. Melloy confirms the virtue of having a former bankruptcy judge on an Article III bench.

The chapter 7 trustee of a corporate debtor had what he believed to be meritorious avoidance claims against the owner. However, the trustee lacked the funds to prosecute the claims.

A creditor offered to buy the avoidance actions for $600,000 cash, reduce its claim by $20 million and share a portion of the proceeds with the trustee. The owner, who was the target of the avoidance actions, made a counteroffer to buy the avoidance claims for $1 million and thereby extinguish the claims.

The trustee decided that the creditor was making a better offer and filed a motion to sell the claims to the creditor free and clear of liens and claims under Section 363(f). The owner objected, but Chief Bankruptcy Judge Thad T. Collins of Cedar Rapids, Iowa, approved the sale to the creditor, holding that chapter 5 avoidance actions are property of the estate that a trustee may sell. *Simply Essentials LLC*, 640 B.R. 922 (Bankr. N.D. Iowa April 6, 2022). To read ABI's report, click here.

The owner appealed, and Judge Collins authorized a direct appeal to the Eighth Circuit. The appeals court accepted the direct appeal and heard argument in April.

The facts being beyond dispute, Judge Melloy reviewed legal conclusions *de novo* and said that the "only issue on appeal is the legal question of whether avoidance actions can be sold as property of the estate."

Property Under Sections 541(a)(1) and (a)(7)

The appeal entailed construction of Section 541(a)(1), which says that "all legal or equitable interests of the debtor in property as of the commencement of the case" are property of the estate,


and Section 541(a)(7), which says, "Any interest in property that the estate acquires after the commencement of the case" is estate property.

Judge Melloy found the answer in opinions from the Supreme Court and the Eighth Circuit. He began with *U.S. v. Whiting Pools Inc.*, 462 U.S. 198 (1983), where the Court held that estate property includes property that had been repossessed before bankruptcy in which the debtor had no possessory interest. Next, he cited *Segal v. Rochelle*, 382 U.S. 375 (1966), for the proposition that "property of the estate includes inchoate or contingent interests held by the debtor prior to the filing of bankruptcy."

From the Eighth Circuit, Judge Melloy drew on *In re Racing Services Inc.*, 540 F.3d 892, 898 (8th Cir. 2008), to say that "creditors may seek permission to obtain derivative standing to bring the avoidance actions on behalf of the estate when a trustee is 'unable or unwilling' to do so."

From binding authority, Judge Melloy held that "avoidance actions are property of the estate under § 541(a)(1)" because "the debtor has an inchoate interest in the avoidance actions prior to the commencement of the bankruptcy proceedings."

"Even if" the debtor didn't have an interest in avoidance actions before bankruptcy, Judge Melloy held that "avoidance actions clearly qualify as property of the estate under subsection (7), which includes '[a]ny interest in property that the estate acquires after the commencement of the case.'"

Contrary Arguments Refuted

Judge Melloy refuted the owner's argument based on statutory construction.

The owner contended that Judge Melloy's interpretation of Sections 541(a)(1) and (a)(7) would create surplusage because Sections 541(a)(3) and (a)(4) specifically bring some after-acquired property into the estate.

Recognizing the realities of the legislative process, Judge Melloy said it was "not unreasonable that Congress would repeat itself in order to ensure the results it intended were followed . . . . Such redundancies are particularly likely when, like in this case, the statute was edited over time to add specificity."

Given amendments to the statute and "the complex nature of the Bankruptcy Code," Judge Melloy said that "the possibility of our interpretation creating surplusage does not alter our conclusion that avoidance actions are part of the estate under the plain language of § 541(a)."


Judge Melloy also rejected the owner's argument that selling avoidance claims would violate the trustee's fiduciary duties. Quite to the contrary, he said that the trustee has a duty to maximize the value of the estate.

Even if there were ambiguity in the statute, Judge Melloy took comfort in "the consensus of courts across the country: avoidance actions are property of the estate." He cited the First, Fifth and Seventh Circuits for holding that avoidance actions are estate property or can be sold by a trustee.

Judge Melloy affirmed the bankruptcy court's order approving sale of the avoidance actions.

Observation

Consider Judge Melloy's holding that "the debtor has an inchoate interest in the avoidance actions prior to the commencement of the bankruptcy proceedings."

Does the statement mean that a debtor has a sufficient interest in avoidance actions before bankruptcy, such that a creditor could obtain a perfected security interest in avoidance actions to persist after bankruptcy?

Generally speaking, a debtor must have an interest in collateral before a security interest can attach. Courts might (or should) hold that the "inchoate" interest mentioned by Judge Melloy is inadequate to confer attachment before bankruptcy.

If a creditor claimed to have a security interest in avoidance actions that had not attached before filing, the automatic stay would preclude attachment after filing, and Section 552(b) would not allow perfection after filing.

Further Observation

Following private practice, Judge Melloy served as a bankruptcy judge in Ohio from 1986 to 1992. After appointment to the district court, he was chair of the bankruptcy committee of the U.S. Judicial Conference.

This writer ventures to say that Judge Melloy readily arrived at the (correct) answer in less than seven pages by virtue of his intimate familiarity with the Bankruptcy Code. Would that every circuit court had a former bankruptcy judge in its midst.

The opinion is *Pitman Farms v. ARKK Food Co. (In re Simply Essentials LLC)*, 22-2011 (8th Cir. Aug. 21, 2023).


***The Supreme Court's narrowing of Rooker-Feldman is showing up in circuit court opinions.***

# *Rooker-Feldman* Held Not to Prevent Relitigation of a Denied Exemption

The Eleventh Circuit twisted itself in knots to hold that neither *Rooker-Feldman* nor issue preclusion prevented the bankruptcy court from disregarding an erroneous state court decision saying that an individual retirement account was NOT exempt.

## The IRA

On default, creditors obtained a $1.6 million judgment against the debtor. The creditors discovered that the debtor had an individual retirement account, or IRA, at a broker. The IRA evidently held about $850,000.

The debtor moved to quash a writ of garnishment that the state court had issued to the broker. The debtor contended that the IRA was exempt from execution in payment of the judgment. The state court decided that the IRA was not exempt, perhaps believing that the debtor had made prohibited transactions.

The state court entered judgment against the broker for $850,000. The judgment allowed the broker to satisfy the judgment by exercising a right of setoff against the IRA.

The judgment became final; the broker liquidated the IRA but never wired the funds to the court clerk, as the judgment specified.

Finally, the debtor filed a chapter 7 petition and claimed an exemption for the funds that had been in the IRA. The creditors objected to the exemption, contending that the funds could not be exempt because they were no longer estate property after the state court found that the IRA was not exempt.

The bankruptcy court ruled against the creditors, concluding that the IRA was exempt. The Eleventh Circuit accepted a direct appeal.

## *Rooker-Feldman*

The creditors contended that the *Rooker-Feldman* doctrine bereft the bankruptcy court of subject matter jurisdiction. In his opinion for the Eleventh Circuit, Chief Judge William Pryor


described the doctrine as meaning, generally, that a loser in state court may not appeal the loss to a federal court.

Acknowledging that the Supreme Court in recent years has narrowed the scope of *Rooker-Feldman*, Judge Pryor quoted precedent from his court:

> Federal courts "do not lose subject matter jurisdiction over a claim 'simply because a party attempts to litigate in federal court a matter previously litigated in state court.'" (quoting *Exxon Mobil*, 544 U.S. at 293).

*Behr v. Campbell*, 8 F.4th 1206, 1210 (11th Cir. 2021).

Judge Pryor explained that the debtor was not asking the bankruptcy court to overturn the state court judgment. Rather, he said, the debtor wanted the bankruptcy court to rule on the "effect" of the judgment.

*Rooker-Feldman* did not apply, Judge Pryor said, because "those arguments about the effect of the Alabama judgment are not invitations to overrule it."

The IRA as Estate Property

On the merits, Judge Pryor described the issue as asking the court to decide whether the judgment in state court "terminated" the debtor's interest in the IRA. The intricacies of state law saved the debtors' bacon.

On a "creditor's bill" utilized by the creditors, Judge Pryor said that a judgment "can" alter a debtor's interest in property. "But," he said, "a judgment does not necessarily extinguish all of a debtor's interests in his property."

Of pivotal significance, the broker retained the funds in the IRA, and the judgment did not give rise to a "personal judgment" against the broker. Furthermore, Judge Pryor said that the judgment created no "duty" for the broker to transfer the funds to the court clerk.

Judge Pryor said that bankruptcy stopped all collection efforts. Because the debtor "had an interest in the retirement account when he filed for bankruptcy," he held that "the bankruptcy court correctly determined that the retirement account was part of [the debtor's] bankruptcy estate."

No Setoff

The creditors contended that the judgment gave the broker a right of setoff, but Judge Pryor saw none because the debtor did not owe a debt to the broker.


There was no personal judgment against the broker, and the judgment only gave the broker a right to transfer the debtor's funds to the court clerk. There being no mutual debts between the broker and the debtor, there was no right of setoff.

Claim Preclusion

The creditors relied on the doctrine of collateral estoppel, now often known as issue preclusion.

Judge Pryor said that issue preclusion under state law prevents relitigation of a fact or law that was litigated and decided in a prior suit. He said that issue preclusion did "not apply because it is not clear that resolution of the issue in this appeal — whether [the debtor's] retirement account was exempt — was a 'necessary' part of the Alabama judgment."

Judge Pryor went on to say that there could have been procedural or substantive grounds on which the state court decided that the IRA was not exempt. When a judgment fails to distinguish between two adequate and independent grounds for a decision, he cited Eleventh Circuit authority for the proposition that the judgment has no preclusive effect.

Judge Pryor affirmed the judgment in favor of the debtor.

The opinion is *Alabama Creditors v. Dorand (In re Dorand)*, 22-14113 (11th Cir. March 14, 2024).


***Whether a creditor violated the automatic stay is not arbitrable in bankruptcy.***

# Bankruptcy Code Overrides Contrary Delaware Corporate Law, Judge Lopez Says

Contrary to holdings by the Delaware Chancery Court, Bankruptcy Judge Christopher M. Lopez of Houston held that Delaware law cannot strip away a member's managerial and voting rights in a limited liability corporation when the member files a chapter 11 petition.

The chapter 11 debtor was a corporation that held a 25% interest in an LLC. Under the management agreement, the debtor held two of five board sets. The management agreement provided that the board could not take certain actions without the consent of at least one of the debtor's board members.

After the debtor filed a chapter 11 petition, the other two members of the LLC invoked Section 18-304 of the Delaware Limited Liability Company Act. It provides that "a person" ceases to be a member of an LLC when that person files bankruptcy voluntarily. "Person" under Delaware law includes a corporation like the debtor.

Using Section 18-304, the other two members changed the management agreement to say that the debtor no longer held a voting or managerial interest in the LLC. They acted without consent from either of the debtor's board members.

The debtor responded by filing a motion in bankruptcy court seeking a declaration that the action violated the automatic stay. The other two members opposed, contending that the action was permissible under Delaware law and that the dispute was subject to an arbitration clause contained in the management agreement.

## Arbitration

In his December 12 opinion, Judge Lopez first dealt with arbitration, observing that "the existence of an arbitration clause in an agreement doesn't mean it is automatic." He cited the Fifth Circuit for the proposition that a bankruptcy court may decline to enforce an arbitration agreement involving a proceeding that "derives exclusively" from the Bankruptcy Code.

Judge Lopez admitted that the LLC management agreement contained a valid arbitration clause, but, he said, "this is not a contract dispute that should be arbitrated. There is nothing in the


LLC Agreement to interpret." Rather, he said that the other members were relying on Delaware corporate law for the idea that the debtor lost its voting and managerial interests.

As a result, Judge Lopez said there is a "direct conflict between § 541 of the Bankruptcy Code and Delaware law," making it "as core of a proceeding as it gets in bankruptcy." He denied the motion to compel arbitration because the stay violation motion was a core proceeding and permitting arbitration would be "inconsistent with the purpose of the Bankruptcy Code."

The Conflict with State Law

The other members of the LLC claimed there was no stay violation because the debtor's loss of voting and managerial rights resulted from state law. Indeed, Judge Lopez cited decisions from the Delaware Chancery court holding that Section 18-304 is not preempted by the Bankruptcy Code and that a debtor retains its economic interest but automatically loses voting and managerial rights.

Judge Lopez observed that the Delaware courts had not dealt with the language in Section 541(a)(1), which creates an estate on filing that retains "all legal or equitable interests of the debtor in property as of the commencement of the case." Finding a direct conflict between Section 541(a) and Section 18-304 of the Delaware Limited Liability Company Act, he said that "parties cannot contract around what becomes estate property, and states cannot legislate estate property away."

Judge Lopez also found a direct conflict with Section 541(c)(1)(B), which includes property in a bankruptcy estate "notwithstanding any provision in an agreement . . . or applicable nonbankruptcy law . . . (B) that is conditioned on the insolvency . . . of the debtor [or] on the commencement of a case under this title."

Judge Lopez said that his decision "clarifies that a member of a Delaware LLC who starts a bankruptcy case keeps *all* legal and equitable interests in the LLC that it held as of the commencement of the case." [Emphasis in original.] He went on to say that "[m]anagerial and voting rights are legal and equitable interests that [the debtor] held as of the petition date, so they are included as property of its estate."

Judge Lopez cited decisions from a district court in New York and bankruptcy courts in West Virginia and Oregon for reaching the same conclusion about similar state laws.

Finding a direct conflict, Judge Lopez held that Section 18-304 must "give way" to Section 541. He found a violation of the automatic stay and voided the amendment to the management agreement that had been made by the other two members.

The opinion is *In re Envision Healthcare Corp.*, 23-90342 (Bankr. S.D. Tex. Dec. 12, 2023).


***The Eighth Circuit aligned with the Ninth Circuit by holding that postpetition appreciation in a home belongs to creditors when a chapter 13 case converts to chapter 7.***

# Another Circuit Says Creditors Take Appreciation When a '13' Case Converts to '7'

Siding with the Ninth Circuit and distinguishing a seemingly similar decision from the Tenth Circuit, the Eighth Circuit held that appreciation in the value of a home during a chapter 13 case belongs to creditors if the case converts to chapter 7 and the appreciation is not covered by the exemption.

With the possible exception of the Tenth Circuit, chapter 13 debtors who live in other circuits are at risk of losing their homes if they convert their cases to chapter 7 or sell the properties while they remain in chapter 13. Consequently, a chapter 13 debtor contemplating the sale of a home should first consult counsel, who should obtain a reliable valuation of the property and research decisions by the presiding judge on the issue.

Even if the presiding judge has ruled in favor of debtors in similar circumstances, counsel should tell their clients that an appellate court might reach a different conclusion, and the debtors may lose their homes.

Perhaps also, chapter 13 clients should be told early in the representation that they should not consider selling their homes unless the appreciation in equity remains covered by the homestead exemption. Clients also should be told that conversion to chapter 7 can result in loss of the home if appreciation exhausts the homestead exemption.

Home Sold During Chapter 13

The debtor confirmed a chapter 13 plan and kept her home. She scheduled her home as worth $130,000 and claimed a $15,000 homestead exemption, the maximum in Missouri. The home had a $107,000 mortgage.

The trustee did not object to the exemption, because the estate would have received nothing had the home been sold on the filing date, taking the costs of sale into consideration. The plan called for the home to revest in the debtor on confirmation.


The debtor converted her case to chapter 7 about two years after filing. The parties agreed that the home had increased $75,000 in value during the chapter 13 case. While in chapter 13, the debtor had reduced the mortgage by almost $1,000. After paying the mortgage and the debtor's $15,000 homestead exemption, the chapter 7 trustee wanted to sell the home, aiming to recover about $62,000 for creditors.

To prevent a sale, the debtor filed a motion to compel abandonment under Section 554. Chief Bankruptcy Judge Brian T. Fenimore of Kansas City, Mo., denied the motion to compel abandonment. *In re Goetz*, 647 B.R. 412 (Bankr. W.D. Mo. Nov. 10, 2022). To read ABI's report, click here. The debtor appealed, but the Eighth Circuit Bankruptcy Appellate panel affirmed in an opinion by Bankruptcy Judge Shon Hastings. *Goetz v. Weber (In re Goetz)*, 651 B.R. 292 (B.A.P. 8th Cir. June 1, 2023). To read ABI's report, click here.

The Circuit Agrees with the BAP

The debtor appealed to the Eighth Circuit but failed to persuade Circuit Judge Bobby E. Shepherd in an opinion on March 8, 2024. He said that the statutory text in Sections 348(f)(1)(A) and 541(a)(6) begins and ends the analysis.

When a chapter 13 case converts to a case under another chapter, Section 348(f)(1)(A) provides:

> 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.

Section 541(a)(6) provides that estate property includes:

> Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

The home was the debtor's property on the original filing and was also her property at the time of conversion. Therefore, the home was property of the chapter 7 estate by virtue of Section 348(f)(1)(A). Without difficulty, Judge Shepherd next concluded that the post-filing increase in equity represented "proceeds" that became chapter 7 estate property under Section 541(a)(6).

Judge Shepherd held "that, under the plain text of the Code, the post-petition, pre-conversion increase in equity in [the debtor's] residence is property of the converted chapter 7 estate." He devoted the remaining three pages of his eight-page decision to rebutting the debtor's arguments.


The debtor contended that the entire home had been exempted when there was no objection to her exemption claim at the time of filing. Judge Shepherd said that the allowed exemption only gave the debtor the maximum state exemption of $15,000, "not the *in-kind* exemption of the entire residence." [Emphasis in original.]

Next, the debtor argued that the home revested in her on confirmation of the chapter 13 plan. Judge Shepherd "easily" rejected the argument, saying that no provision of chapter 13 "holds sway" once the case converts to chapter 7, citing *Harris v. Viegelahn*, 575 U.S. 510, 520 (2015).

The snapshot rule fared no better. A picture of the estate on the original filing date, he said, has "no bearing on whether the post-petition, pre-conversion increase in equity in [the debtor's] residence is property of the converted estate" because Section 522(a)(2) "is expressly confined to that section only."

As a matter of policy, the debtor urged the circuit to recognize that a debtor is not to be punished for "attempting chapter 13." Judge Shepherd said he was "sensitive" to the hardship the decision would impose on the debtor, but he quoted the Supreme Court for saying that "policy arguments" cannot "overcome" provisions in the Bankruptcy Code.

Finally, the debtor wanted the Eighth Circuit to follow the Tenth Circuit's decision in *In re Barrera*, 22 F.4th 1217 (10th Cir. 2022). There, the Tenth Circuit allowed the debtor to retain the appreciation in a home sold before conversion. To read ABI's report, click here.

Judge Shepherd said that the Tenth Circuit answered "a different question." He affirmed the BAP.

The opinion is *Goetz v. Weber (In re Goetz)*, 23-2491 (8th Cir. March 8, 2024).


***Splitting with the Tenth Circuit, the Ninth Circuit holds that chapter 13 debtors lose post-petition appreciation in a home if the case converts to chapter 7.***

# Circuits Are Now Split on Who Gets Appreciation in a Home When a '13' Coverts to '7'

Splitting with the Tenth Circuit, a divided panel on the Ninth Circuit held that the post-petition appreciation in the value of a home belongs to creditors when a chapter 13 debtor converts the case to chapter 7.

The dissenter on the Ninth Circuit said that the majority "effectively punishes the [debtors] for filing under Chapter 13 with the forced sale of their home. Because that outcome is not the best reading of the Bankruptcy Code or our precedents," the dissenter said he would have held, "consistent with the Tenth Circuit, that postpetition, preconversion appreciation belongs to the [debtors] rather than the converted Chapter 7 estate."

## Forced to Sell the Home

Eighteen months after confirming a chapter 13 plan, a couple were forced to convert their case to chapter 7 because the husband developed Parkinson's Disease and could no longer work.

In the chapter 13 case, the debtors had scheduled their home as being worth $500,000. There was no equity in the home given the $375,000 mortgage and the debtor's claimed homestead exemption of $125,000.

After conversion, the chapter 7 trustee alleged that the property was worth $700,000 and filed a motion for authority to sell the home. The debtors argued that the valuation at conversion didn't matter because appreciation during chapter 13 belonged to them.

Bankruptcy Judge Marc Barreca of Seattle disagreed with the debtors and held that post-petition, pre-conversion appreciation belongs to the chapter 7 estate. *In re Castleman*, 631 B.R. 914 (Bankr. W.D. Wash. June 4, 2021). To read ABI's report, click here.

The debtors appealed and lost again in district court. *In re Castleman*, 21-00829, 2022 BL 229708, 2022 US Dist. Lexis 116941, 2022 WL 2392058 (W.D. Wash. July 1, 2022). To read ABI's report, click here. The debtors appealed to the circuit.

## The Majority Opinion


For the majority, Circuit Judge Michael D. Hawkins said that the courts are "heavily divided." He cited the Tenth Circuit for holding that post-petition appreciation in a nonexempt asset belongs to the debtor on conversion from chapter 13 to chapter 7. *See In re Barrera*, 22 F.4th 1217 (10th Cir. 2022). To read ABI's report, click here. However, he did not cite his own Ninth Circuit Bankruptcy Appellate Panel for reaching the same result as the Tenth Circuit by giving appreciation to the debtor. *See Black v. Leavitt (In re Black)*, 609 B.R. 518 (B.A.P. 9th Cir. Dec. 31, 2019). To read ABI's report, click here.

Among the courts bestowing appreciation on creditors, Judge Hawkins cited the bankruptcy court's opinion in *In re Goetz*, 647 B.R. 412 (Bankr. W.D. Mo. Nov. 10, 2022). To read ABI's report, click here. [Note: Judge Hawkins did not cite the Eighth Circuit Bankruptcy Appellate Panel's affirmance in *Goetz v. Weber (In re Goetz)*, 651 B.R. 292 (B.A.P. 8th Cir. June 1, 2023). To read ABI's report, click here. Note also that *Goetz* is on appeal to the Eighth Circuit.]

Several statutes are in play. Section 348(f)(1), which underwent substantial amendment in 1994, provides that "property of the estate in the converted case shall consist of property of the estate, as of the date of filing of the petition, that remains in the possession of or is under the control of the debtor on the date of conversion."

The amendment was intended to overrule caselaw holding that property obtained after filing a chapter 13 petition becomes estate property once the case converts to chapter 7.

Primarily relied on by the majority, Section 541(a)(6) provides that estate property includes "[p]roceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case."

Citing *In re Goins*, 539 B.R. 510, 516 (Bankr. E.D. Va. 2015), Judge Hawkins said that the equity is "inseparable" from the real estate. Citing previous Ninth Circuit opinions and Section 541(a)(6), he said that post-petition appreciation in real estate belongs to the estate, not the debtor. *Schwaber v. Reed* (*In re Reed*), 940 F.2d 1317, 1323 (9th Cir. 1991); and *Wilson v. Rigby*, 909 F.3d 306, 309 (9th Cir. 2018). [Note: Judge Hawkins did not mention that the two Ninth Circuit opinions dealt with cases in chapter 7, not conversions from chapter 13.]

Although the two opinions were chapter 7 cases, Judge Hawkins found "no textual support for concluding that § 541(a) has a different meaning upon conversion from Chapter 13."

Judge Hawkins said that "many" cases reached a different conclusion by reference to the legislative history surrounding the 1994 amendment to Section 348(f). Those courts read the amendment's legislative history as saying that appreciation after filing in chapter 13 belongs to the debtor.


Judge Hawkins did "not look to legislative history for guidance" because he concluded that the statute was not ambiguous.

Citing the Tenth Circuit's *Barrera* decision, Judge Hawkins said that "some" courts give appreciation to the debtor by relying on Section 1327(b), the statute that revests estate property in the debtor on chapter 13 confirmation. However, he said that "§ 348(f) only clarified that newly acquired, post-petition property would not become part of the converted estate."

"In sum," Judge Hawkins said, "the plain language of § 348(f)(1) dictates that any property of the estate at the time of the original filing that is still in [the] debtor's possession at the time of conversion once again becomes part of the bankruptcy estate, and our case law dictates that any change in the value of such an asset is also part of that estate. In this case, that property increased in value."

In a footnote after affirming the lower court's holding that appreciation enhanced the chapter 7 estate, Judge Hawkins said that the decision did not resolve the debtors' argument to have an administrative claim for payments they made on the mortgage after confirmation of the chapter 13 plan.

The Dissent

Circuit Judge Richard C. Tallman opened his dissenting opinion by saying that the majority created "a circuit split and effectively punishes the [debtors] for filing under Chapter 13 with the forced sale of their home." As a result, he said that "the majority sacrifices the text of the bankruptcy statutes on the altar of simplicity."

Judge Tallman characterized the majority as reaching a "simple resolution" by holding that appreciation in chapter 13 goes to the estate "because we have held [that] appreciation becomes part of the estate in a Chapter 7 case."

"But simplicity," Judge Tallman said, "cannot take precedence over the text of the Bankruptcy Code, and if we read § 348(f) in light of the Code 'as a whole' — rather than just § 541(a) — [*Wilson v. Rigby*] is not dispositive." The "remainder" of the Bankruptcy Code, he said, "clarifies" that "property of the estate" is defined differently in chapter 13 than it is in chapter 7.

In view of Section 1327(b), Judge Tallman said that the debtor once again becomes the owner of the home on confirmation. "It follows," he said, "that when a Chapter 13 plan has been confirmed, appreciation accrues to the debtor."

Judge Tallman quoted the decision by "our Bankruptcy Appellate Panel" in *Black* for "holding that 'the revesting provision of the confirmed plan means that the debtor owns the property outright


and that the debtor is entitled to any postpetition appreciation.'" *Black, supra*, 609 B.R. at 529. The Tenth Circuit, he said, "reached a similar conclusion" in *Barrera*.

Judge Tallman went on to cite *Barrera* for holding that Section 541(a)(6) is only operative before confirmation because confirmation revests property in the debtor. He then quoted the Tenth Circuit for saying that proceeds generated from property after confirmation do not become estate property.

Consistent with the Tenth Circuit, Judge Tallman said that he "would hold . . . that postpetition, preconversion appreciation belongs to the [debtors] rather than the converted Chapter 7 estate."

On top of the majority's erroneous interpretation of the statute, Judge Tallman said that "the majority's reading of § 348(f)(1)(A) is also inconsistent with the statute's structure, object, policies, and legislative history." Citing the legislative history accompanying the adoption of Section 348(f)(1)(A) in 1994, he said, "Clearly, Congress believed that home equity which accrued during Chapter 13 proceedings should not be included in the converted estate."

Where the majority declined to take guidance from legislative history, Judge Tallman said it was "consistent with the text of the Bankruptcy Code, directly relevant to the case at hand, and unequivocally confirms that appreciation in the value of the [debtors'] home should not become part of the converted estate."

To this writer, Judge Tallman cast his reading of the statute in terms of fairness. Had the debtors originally filed in chapter 7, he said that all of their home equity would have been exempt. By having taken a shot at chapter 13, he said they were left in a "worse position," which he called "the situation Congress sought to prevent."

Although he recommended that Congress once again amend Section 348(f) "to make the answer clear," Judge Tallman said he "would hold that the appreciation belongs to the [debtors]."

The opinion is *Castleman v. Burman (In re Castleman)*, 22-35604 (9th Cir. July 28, 2023).


# *Claims*


***Reversing the BAP, the Ninth Circuit (erroneously) holds that state law cannot demand more documentation for a proof of claim than Bankruptcy Rule 3001 requires for prima facie validity.***

# 9th Circuit: State Law Can't Require More than What Rule 3001 Requires for Claim Validity

Reversing the Bankruptcy Appellate Panel, the Ninth Circuit evidently held that a claim will be allowed if the creditor supplies all of the information required by Bankruptcy Rule 3001(c), even when state law requires further documentation and authentication.

Respectfully, the BAP was right. Rule 3001(c) contains the guidelines for the form and content of a proof of claim to establish *prima facie* validity of a claim. Once *prima facie* validity is established, the burden shifts to the debtor to demonstrate the invalidity of the claim on one of the grounds in Section 502(b).

In the Ninth Circuit case, the debtor appears to have shown that the claim was not valid under Nevada law for lack of required documentation, thereby establishing grounds for disallowance under Section 502(b)(1), but the Court of Appeals held otherwise.

The Credit Card Claim

The lender filed a proof of claim in a chapter 13 case for a credit card debt of about $8,000. The debtor objected, contending that the lender had not supplied all of the documentation and authentication required by Nevada law when suing to collect credit card debt. The debtor conceded that the proof of claim contained all of the information and supporting documentation required by Rule 3001(c).

The bankruptcy court allowed the claim, but the BAP reversed and remanded. The circuit authorized an interlocutory appeal and reversed the BAP in a nonprecedential, *per curiam* opinion on November 21.

The Ninth Circuit based its reversal on *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938). "Under *Erie* principles," the appeals court said, "federal bankruptcy courts apply federal procedural law and state substantive law."


"To determine whether a state law applies in a federal action," the Ninth Circuit quoted its own precedent to say, "'we decide whether the state law conflicts with a valid [federal procedural rule].' *Martin v. Pierce Cnty.*, 34 F.4th 1125, 1128 (9th Cir. 2022)."

The circuit panel said that "Rule 3001 clearly controls over Nevada laws." More specifically, the circuit found that "Nevada laws conflict with this federal rule because the two give different answers to the same question: What must a creditor provide in support of a proof of claim on an open-end credit card account?"

The Ninth Circuit said that Rule 3001 is a "typical" and "valid procedural rule" that does "not impinge on substantive rights" and "does no more than set out the procedural requirements for a proof of claim."

"Consequently," the Ninth Circuit held that "Rule 3001 prevails over the Nevada laws, meaning that the Nevada laws are not 'applicable law' that can render a claim 'unenforceable' under 11 U.S.C. § 502(b)(1)."

The Ninth Circuit reversed and remanded, saying that the lender's "failure to comply with Nev. Rev. Stat. §§ 97A.160 and 97A.165 is not a ground for disallowing its proof of claim."

The BAP Opinion

Respectfully, the Ninth Circuit's decision does not hold water compared to the BAP's opinion, which, likewise, was nonprecedential. *See Myers v. LVNV Funding (In re Myers)*, 22-1005, 2022 BL 264865, 2022 Bankr. Lexis 2080, 2022 WL 3012567 (B.A.P. 9th Cir. July 19, 2022).

The debtor appealed after the bankruptcy court allowed the claim. In the BAP, the debtor admitted that the credit card lender had supplied all of the information required by Rule 3001. However, Nevada law requires more "in any action brought to collect a debt owed to an issuer." NRS § 97A.160(1).

Pertinent to the appeal, Section 97A.160 requires submission of "the written application for a credit card account" plus "periodic billing statements." Significantly, the Nevada statute requires that the information be "authenticated."

When credit card debt is being collected by a purchaser of the debt, Section 97A.165 additionally requires the complaint to include, among other things, the name of the issuer of the card and four digits of the original account number. Without this information, the statute says that "[n]o judgment [may be entered] in favor of the purchaser of credit card debt."

The BAP characterized the debtor as contending that "the documentation provided was insufficient to enforce the debt under Nevada law."


The debtor had lodged a request for the production of authenticated documentation required by Nevada law. Specifically, the BAP said that the lender "did not produce either an authenticated written credit card application or authenticated evidence that Debtors incurred charges on the account and made payments thereon."

The BAP said that the lender "does not directly address the real issue, which is the enforceability of the claim under Nevada law." The BAP never said that the proof of claim was deficient.

The BAP reversed the bankruptcy court and remanded, holding that the lender "did not provide the documentation required to enforce its claim under applicable law."

Observations

The question is this: Are the requirements in the Nevada statute procedural or substantive? For instance, is the requirement to produce an authenticated credit card agreement substantive or procedural? Is the requirement of producing authenticated statements merely procedural, or is it substantive?

To this writer, the question seems to be answered by NRS § 97A.165(b)(2), which says that "no judgment may be entered in favor of the purchaser of credit card debt" unless the purchaser "has satisfied the *standards of proof* set forth in subsections 1 and 2 of NRS 97A.160." [Emphasis added.] The Nevada statute does not require the documentation to be attached to the complaint, but it lays out the evidence that must be submitted to validate a claim.

To this reader, the "standards of proof" required by Nevada law mean that state law is substantive, not procedural. Consequently, the lack of proof required by state law should result in disallowance under Section 502(b)(1) because the claim would be "unenforceable against the debtor under . . . applicable law . . . ."

The Ninth Circuit apparently failed to recognize that compliance with Rule 3001 only establishes *prima facie* validity of a claim and does not specify all of the elements required for allowance of a claim.

As shown by the Ninth Circuit's decision, allowing a claim on credit card debt by supplying information required by Rule 3001 and nothing more has the effect of nullifying state consumer protection laws, to this writer's way of thinking. The same might be true with regard to allowance of a secured claim based on a mortgage, given state law requirements to establish the validity and enforceability of a mortgage.


If the Ninth Circuit's decision means that credit card lenders in Nevada will have allowable claims in bankruptcy that would be disallowed in state court, it remains to be seen whether lower courts will feel bound by the Ninth Circuit's nonprecedential opinion.

The opinions herein are those of the writer, not ABI.

The opinion is *LVNV Funding v. Myers (In re Myers)*, 22-16615 (9th Cir. Nov. 21, 2023).


***The circuits are now split 3/1, with the majority finding a waiver of sovereign immunity under Section 544(b)(1) for lawsuits by a trustee based on claims that an actual creditor could not have brought outside of bankruptcy.***

# IRS Has No Sovereign Immunity to Bar a Fraudulent Transfer Suit Under Section 544(b)

Siding with the majority on a split of circuits, the Tenth Circuit held that the waiver of sovereign immunity in Section 106(a) permits a bankruptcy trustee to sue the government for receipt of a fraudulent transfer under Section 544(b)(1), even though an actual creditor could not have sued the government outside of bankruptcy.

The Tenth Circuit found guidance from the sovereign immunity decision handed down by the Supreme Court in June. *Lac du Flambeau Band of Lake Superior Chippewa Indians v. Coughlin,* 22-227, 2023 BL 204482, 2023 US Lexis 2544 (June 15, 2023). To read ABI's report, click here.

The Fraudulent Transfer to the IRS

The case arose from a typical fraudulent transfer to the Internal Revenue Service: A corporation paid federal income taxes owed by one of its owners.

The corporation's chapter 7 trustee invoked Section 544(b)(1) to sue the IRS for receipt of a fraudulent transfer under Utah law. The section allows a trustee to "avoid any transfer of an interest of the debtor in property . . . that is voidable under applicable law by a creditor holding an [allowable] unsecured claim."

The government agreed there was an actual creditor and admitted the elements of a constructively fraudulent transfer. However, the government contended that sovereign immunity would have prevented an actual creditor from suing the IRS outside of bankruptcy, thus disabling the trustee from suing under Section 544(b)(1).

In response, the trustee argued that the waiver of sovereign immunity as to Section 544 contained in Section 106(a) allowed suit based on a state-law claim.

On cross motions for summary judgment, Bankruptcy Judge R. Kimball Mosier of Salt Lake City ruled in favor of the trustee and entered judgment for about $145,000. The IRS appealed to


the circuit after the district court affirmed. *See U.S. v. Miller*, 20-00248, 2021 BL 340200 (D. Utah Sept. 08, 2021). To read ABI's report on the district court affirmance, click here.

The Circuit Split

In his June 27 opinion, Tenth Circuit Judge Bobby R. Baldock laid out the split of circuits.

The Seventh Circuit first tackled the question in 2014 by ruling that the immunity waiver in Section 106(a) did not allow suit against the state, reasoning that Section 106(a) did not modify the actual creditor requirement in Section 544(b). *In re Equip. Acquisition Res. Inc.*, 742 F.3d 743 (7th Cir. 2014). Judge Baldock said that the Chicago-based appeals court "never meaningfully addressed the scope of § 106(a) as reflected in its text."

Judge Baldock interpreted the Seventh Circuit's opinion as "effectively" erecting a "total ban" on fraudulent transfer suits against governmental units under Section 544(b)(1).

On the other side of the fence, the Ninth and Fourth Circuits both held that the waiver of immunity in Section 106(a) covers claims against the government under state law. *See In re DBSI, Inc.*, 869 F.3d 1004 (9th Cir. 2017); and *Cook v. U.S. (In re Yahweh Center Inc.),* 27 F.4th 960 (4th Cir. 2022). To read ABI's reports, click here and here.

To decide which faction had the better reasoning, Judge Baldock took counsel from *Lac du Flambeau*, where the Court said that the intent of Congress to waive sovereign immunity must be "unmistakably clear," although there is no requirement for the statute to use "magic words."

Focusing on the language in Section 106(a), Judge Baldock noted that Congress "abrogated" immunity "with respect to" Section 544. The Supreme Court, he said, held that "with respect to" has a "broadening effect."

Like the Fourth and Ninth Circuits, which were "faithful to the text of Code § 106(a)," Judge Baldock held:

> [T]he critical phrase "with respect to" in § 106(a)(1) clearly expresses Congress's intent to abolish the Government's sovereign immunity in an avoidance proceeding arising under § 544(b)(1), regardless of the context in which the defense arises.

Judge Baldock found support for his holding in Section 106(a)(2), which says that the court "may hear and determine *any* issue arising *with respect to* the application of" Section 544. [Emphasis in original.]


Judge Baldock made "short work" of the government's alternative argument based on field preemption. Had Congress believed that Section 544(b) posed an obstacle to the collection of income taxes, he said that "Congress surely would have added an express preemption provision to § 544(b) exempting the Government from its operation just as it provided an exemption for a transfer of charitable contributions in subsection (b)(2)."

Contrary to the Seventh Circuit, Judge Baldock held:

> Code § 106(a) waives the Government's sovereign immunity both as to the Trustee's proceeding under Code § 544(b)(1) and the underlying Utah state law cause of action subsection (b)(1) authorizes the Trustee to rely on to avoid the debtor's tax transfers made on behalf of its principals in this case.

The opinion is *U.S. v. Miller*, 21-4135 (10th Cir. June 27, 2023).


# Cross-Border Insolvency & Madoff


***For the time being, the Eleventh Circuit has split with the Second Circuit on whether a chapter 15 debtor must have property in the U.S. to gain foreign recognition.***

# Eleventh Circuit Invited to Sit *En Banc* on Eligibility for Chapter 15 Recognition

Three opinions by an Eleventh Circuit panel in one chapter 15 appeal are a prelude to a petition for rehearing *en banc* or a petition for *certiorari* to resolve a circuit split. Either would decide whether a bankruptcy court may grant foreign main recognition under chapter 15 even if the debtor has no residence, domicile, place of business or property in the U.S.

As it now stands, the Second Circuit has held in *In re Barnet*, 737 F.3d 238 (2d Cir. 2013), that a bankruptcy court may not grant recognition if the debtor has no residence, domicile, place of business or property in the U.S., a seeming requirement under Section 109(a).

Under former Section 304, the Eleventh Circuit had held that property, residence or domicile in the U.S. was *not* required to maintain an ancillary proceeding. *In re Goerg*, 844 F.2d 1562 (11th Cir. 1988). Section 304 was repealed in 2005 alongside the adoption of chapter 15. In the case on appeal to the Eleventh Circuit, the bankruptcy court and the district court both concluded that *Goerg* remained good law given the similarity between prior Section 304 and chapter 15.

Both lower courts in the case on appeal predicted that the Eleventh Circuit would follow *Goerg*, creating a split with *Barnet* from the Second Circuit. Their predictions were correct as a technical matter, but the story isn't over, because the April 3 opinions from the Eleventh Circuit are an invitation for a petition for rehearing *en banc* or a petition for *certiorari*.

Note: Other lower courts have declined to follow *Barnet*. Bound by *Barnet*, courts in the Second Circuit routinely hold that Section 109(a) is satisfied if the foreign representative has a retainer lodged with a law firm in the district where the chapter 15 petition was filed.

Whether it be the Supreme Court or the Eleventh Circuit sitting *en banc*, the outcome will depend on whether the court adopts a simplistic approach to statutory interpretation.

The Foreign Debtor


A resident and citizen of Oman, the debtor was divorced in the U.K., where the court awarded £24 million to his former wife. The debtor was adjudged bankrupt in the U.K. when he refused to pay.

The joint trustees in the U.K. filed a chapter 15 petition in Florida, seeking foreign main recognition. They intended to use powers under chapter 15 to conduct discovery regarding Florida corporations that the debtor owned and that allegedly had real property in Florida worth $94 million.

The debtor conceded that the liquidators satisfied all requirements for recognition under Section 1517. However, the debtor contended that he no longer owned any property in the U.S. The U.K. trustees took the position that the debtor may have fraudulently transferred the assets.

Based on *Barnet* and the idea that he had no property in the U.S., the debtor opposed recognition by arguing he did not fall within the description of a debtor in Section 109(a). Section 109 is made applicable in chapter 15 cases by Section 103.

Section 109(a) says:

> [O]nly a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title.

Predicting that the Eleventh Circuit would follow *Goerg* and split with *Barnet*, Bankruptcy Judge Lori V. Vaughan granted foreign main recognition. *In re Al Zawawi*, 634 B.R. 11 (Bankr. M.D. Fla. Aug. 31, 2021). To read ABI's report, click here.

The debtor appealed but lost in a decision by District Judge Gregory A. Presnell, who upheld recognition found by Judge Vaughan. *Al Zawawi v. Diss (In re Al Zawawi)*, 637 B.R. 663 (M.D. Fla. Feb. 28, 2022). To read ABI's report, click here.

The Opinion for the Circuit

The debtor appealed. In one of three opinions resolving in the appeal, Circuit Judge Barbara Lagoa wrote the opinion for the panel. She found appellate jurisdiction by holding that an order granting foreign recognition resolved a discrete bankruptcy proceeding and thus was a "final" order.

On the merits, Judge Lagoa framed the question as whether the definition of a debtor in Section 109(a) applies to chapter 15 cases. She said that a "plain reading" of Section 103(a) means that Section 109(a) "does apply to Chapter 15 cases." However, she cited *Goerg* for holding that the definition of a "debtor" did not apply to ancillary proceedings under former Section 304.


"Because we are bound by [*Goerg*] and understand its reasoning to be sufficiently applicable to the question presented in this case," Judge Lagoa held, "we are compelled to respond in the same manner today."

Judge Lagoa characterized what *Goerg* found to be a "point of tension" between the definitions of a "debtor" and a "foreign proceeding." Deciding to follow the definition of a "foreign proceeding," she said that the court in *Goerg* "relied on the 'purpose' of § 304 to break the tie" and to hold "that 'debtor' eligibility under the [Bankruptcy] Code was not 'a prerequisite to section 304 ancillary assistance.'"

Judge Lagoa decided "that the former § 304 and Chapter 15 are sufficiently similar in terms of their purposes such that our decision in *Goerg* controls our analysis in this case."

Following "the logic of *Goerg*," Judge Lagoa affirmed the bankruptcy court's grant of recognition, "based on the definition of 'foreign proceeding' in § 101(12), as informed by the purpose of Chapter 15." In light of *Goerg*, she said that "debtor eligibility under Chapter 1 is not a prerequisite for the recognition of a foreign proceeding under Chapter 15."

Judge Lagoa's 'Concurrence'

Immediately after her opinion for the panel, Judge Lagoa wrote a five-page special concurrence that reads like a dissent from her own opinion. In the opening paragraph, she said:

> I agree that *Goerg* compels the result reached by the majority opinion. But if we were writing on a clean slate, I would reverse the bankruptcy court's determination that 11 U.S.C. § 109(a) does not apply to Chapter 15 cases in accordance with the plain text of 11 U.S.C. § 103(a).

Judge Lagoa spent the remainder of her concurrence refuting "the Foreign Representatives' four main arguments supporting the application of *Goerg* and why I do not believe they are supported by the text of the Bankruptcy Code."

Summarizing, Judge Lagoa said, "§ 103(a) plainly provides that § 109(a) applies to cases under Chapter 15, and I do not find any of the Foreign Representatives' counterarguments based on the text of the Bankruptcy Code to be persuasive." Were she not bound by *Goerg*, she said she would "adhere to the plain meaning of § 103(a) and reverse the bankruptcy court's determination that § 109(a) does not apply to Chapter 15 cases."

The Concurrence by Judge Tjoflat


Senior Circuit Judge Gerald B. Tjoflat wrote a 47-page special concurrence that reads like a dissent from Judge Lagoa's concurring opinion that would overrule *Goerg*. Judge Tjoflat's belief in the continuing validity of *Goerg* is not surprising, because he was the author of *Goerg*.

Judge Tjoflat said that he "respectfully disagree[s] with the majority's interpretation of *In re Goerg* as abstract purposivism." In large part tracking an *amicus* brief by four experts on chapter 15, he saw the Eleventh Circuit as "bound by *In re Goerg* because the current definition of a foreign proceeding is substantially the same as the one we soundly interpreted in *In re Goerg*."

The *amicus* brief was submitted by the American College of Bankruptcy, Prof. Jay L. Westbrook, retired bankruptcy judge Allan L. Gropper, Daniel M. Glosband and Patricia A. Redmond. Prof. Westbrook and Mr. Glosband were the primary draftsmen assisting the Department of State in drafting chapter 15.

Judge Tjoflat said that adopting the debtor's "position . . . would reward fraudulent transfers of a foreign debtor's assets in the United States because once the debtor sells his American property, the foreign proceeding cannot be recognized."

Judge Tjoflat characterized the debtor as saying that "if a United States Bankruptcy Court finds a potentially fraudulent transfer of all a foreign debtor's American assets was successfully executed, the Chapter 15 case is over because the debtor would be ineligible to then file for bankruptcy in the United States."

"Common sense," Judge Tjoflat said, "tells us this result almost certainly cannot be correct." Congress, he said, "*could* write such a self-defeating statute. But in my view, it did not do so." [Emphasis in original.]

Scholarly Commentary

Daniel Glosband provided ABI with the following commentary.

> I am pleased that the Eleventh Circuit affirmed the lower courts in *Al Zawawi* and that section 109(a) will not be an Eleventh Circuit requirement for chapter 15 recognition.
>
> However, I am disappointed that the panel decision affirmed solely based on its view that it was bound by its 1988 precedent *In re Goerg* rather than by adopting and bringing current the *Goerg* analysis. Judge Lagoa said rather tersely in her Special Concurrence that she would have reversed if she were not bound by *Goerg*, based on an incomplete and wholly unreasoned analysis.


> Judge Tjoflat's Special Concurrence was excellent, providing statutory context and analysis for both *Goerg* (which he wrote over 30 years ago) and *Al Zawawi*. As instructed by Congress (in section 1508), he reviewed relevant UNCITRAL materials (the Guide to Enactment and Interpretation and the UNCITRAL collection of caselaw) and concluded correctly (as emphasized by the *amici curiae* in our brief) that the nature of the debtor in the foreign proceeding was not relevant to recognition since recognition focuses on the eligibility of the foreign proceeding and not of the debtor in that proceeding.
>
> Judge Tjoflat also pointed out the abusive possibilities of applying Section 109(a) — a debtor in a foreign proceeding could fraudulently transfer any U.S. assets (even if they would otherwise be a legitimate target of the foreign representative) and prevent recognition, thwarting recovery efforts by the foreign representative.

Mr. Glosband is of counsel in the Boston office of Goodwin Procter LLP.

The opinions are in *Al Zawawi v. Diss (In re Al Zawawi)*, 22-11024 (11th Cir. March 3, 2024).


***Prof. Westbrook believes there is no common law alternative to chapter 15.***

# Third Circuit Creates a Common Law Alternative to Chapter 15

Based on comity, the Third Circuit has crafted a wholly common law alternative to chapter 15.

When a foreign liquidator has not filed a petition for recognition of a foreign bankruptcy proceeding under chapter 15, the Third Circuit has laid down complex rules explaining when common law notions of comity, alone, will permit a U.S. court to enjoin or dismiss a case in the U.S. involving a defendant in bankruptcy proceedings abroad.

The opinion makes chapter 15 either optional or irrelevant.

The Third Circuit's disregard of chapter 15 is "most unfortunate," according to Prof. Jay L. Westbrook, the country's leading expert on cross-border insolvency and one of the drafters of chapter 15. He told ABI:

> Reading the Third Circuit's opinion had an otherworldly feel, a case in an alternative universe where the adoption of Chapter 15 never happened. Hamlet without the Prince.

Before we offer Prof. Westbrook's critique of the Third Circuit's opinion, here's what happened:

The Singaporean Defendant

As plaintiff in two lawsuits in federal district court in New Jersey, a Delaware corporation sued a Singaporean corporation whose primary place of business was in Singapore. The defendants' directors agreed to entry of a consent judgment for $29 million against the defendant corporation.

Later, the liquidator for the Singapore corporate defendant moved to vacate both judgments under Rule 60(b), asserting that the corporation was in liquidation in Singapore that began before the suits were filed in New Jersey and on which the directors had no authority to act when they consented to entry of judgment.

The liquidator asserted that he could not have intervened because he had no notice of the suit in New Jersey. The district court vacated both judgments based on evidence of "misconduct" in


Rule 60(b)(3). Later, the liquidator moved to dismiss the suits under Rule 12(b)(2) and (b)(6) on grounds of "international comity."

Based on comity, the district court dismissed both suits. The plaintiff appealed.

In her February 1 opinion, Third Circuit Judge Arianna J. Freeman said that the district court had ruled "despite little recent guidance from this Court." Indeed, Judge Freeman is correct. Prof. Westbrook observed that the "cases cited in support of the Third Circuit's decision all predate the adoption of Chapter 15 in 2005."

Without referring to the requirements in chapter 15, Judge Freeman said that the appeals court would "now clarify the standard courts must apply when deciding whether to abstain from adjudicating a case in deference to what is essentially a pending foreign bankruptcy proceeding."

Judge Freeman reviewed the district court's grant of comity for abuse of discretion. She never mentioned that she was creating a common law alternative to chapter 15, nor did she discuss whether a common law equivalent to chapter 15 is even permissible. The Third Circuit opinion might even be read to add an additional layer of requirements on top of chapter 15.

This writer submits that review should have been *de novo*, to inquire as to whether the district court applied the correct law by failing to analyze the defendant's motion to dismiss in light of chapter 15.

New Rules for Abstention Based on Comity

Judge Freeman explained that the appeal "involves adjudicatory comity, which is a discretionary act of deference to a foreign court" to be invoked "when there is or was a 'parallel' foreign proceeding." To decide whether there was a parallel proceeding, she drew an analogy to "whether a civil action is 'related to' a United States bankruptcy proceeding."

Judge Freeman said that a suit is "related to" a bankruptcy "if the outcome could alter the debtor's rights, liabilities, options, or freedom of action." She therefore held that a lawsuit in the U.S.

> is "parallel" to a foreign bankruptcy proceeding when: (1) the foreign bankruptcy proceeding is ongoing in a duly authorized tribunal while the civil action is pending before the United States court; and (2) the outcome of the United States civil action may affect the debtor's estate. [Citation omitted.]

With regard to the existence of a parallel foreign proceeding, Judge Freeman saw no reason for remand "because parallelism is established by the undisputed facts." The $29 million judgment, she said, would "plainly affect" the liquidation in Singapore.


After finding a parallel proceeding, Judge Freeman cited *Hilton v. Guyot*, 159 U.S. 113, 164 (1895), to say that the U.S. court "then reviews the procedures and the system of laws in the foreign court and assesses whether the foreign proceedings are likely to (or likely did) result in the impartial administration of justice." However, she said, "foreign bankruptcy proceedings need not function identically to similar proceedings in this country in order to be consistent with the United States' policy of equality."

Judge Freeman concurred with the district court's findings about the liquidation proceedings in Singapore, where she saw a "policy of equal distribution of assets among similarly situated creditors" and a prohibition of actions against the debtor without permission from the court in Singapore.

However, Judge Freeman remanded the case, because the district court had not made all of the findings in the Third Circuit's new test for comity. After deciding to invoke comity, she did say that the court "ordinarily should stay the civil action or dismiss it without prejudice."

Observations by Prof. Westbrook

With the adoption of chapter 15 in 2005, Congress laid out intricately crafted procedures and standards for recognizing bankruptcy proceedings abroad, halting suits in the U.S. against foreign debtors and enforcing the rulings of foreign bankruptcy proceedings in the U.S.

The Third Circuit, however, did not discuss the pivotal question: In view of the existence of chapter 15, are there common law grounds that a foreign liquidator may employ to halt a lawsuit in the U.S., or is chapter 15 the exclusive remedy?

Prof. Westbrook noted how the Third Circuit failed to recognize that Section 1509(c) was designed to prevent the invocation of common law in place of chapter 15.

The professor explained how Section 1509(c) "requires that a request for comity by a foreign liquidator be accompanied by a certificate of recognition from the U.S. court that has recognized the foreign proceeding." The professor explained that Section 1509(c) "was the subject of considerable discussion among those of us advising the government about the drafting of Chapter 15 and various responsible executive department officials."

As one of the drafters of chapter 15, Prof. Westbrook wrote an article in 2005 saying explicitly that common law was no longer an alternative for foreign liquidators to halt lawsuits in the U.S. He said:

> Now the foreign representative must go through the Chapter 15 process to get the United States action stayed. **Deferral for comity reasons in other courts is**


> **not authorized without the Chapter 15 process**. The goal is to have the Chapter 15 criteria applied uniformly and by courts with specialized knowledge of the bankruptcy process. [Emphasis added.]

Westbrook, *Chapter 15 at Last*, 79 Am. Bankr. L.J. 713 at 726 (2005).

Prof. Westbrook said that "the Third Circuit could have considered that Section 1509(f) provides an exception to the recognition requirement solely for suits by the liquidator to recover a claim which is property of the debtor, but the Third Circuit in this case does not cite it or anything else in Chapter 15."

"Worse still," the professor said, the Third Circuit "announced that its analysis must be applied in all cases of a comity request by a foreign liquidator going forward. Why would a foreign representative bother to get recognition under Chapter 15 when a dismissal of a U.S. lawsuit requires only a motion to dismiss unaccompanied by all the protections for the U.S. plaintiff embodied in Chapter 15?"

Prof. Westbrook occupies the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law.

A Final Observation

The Singaporean liquidator could have obtained the same relief and more by filing a chapter 15 petition. The liquidator likely would have obtained foreign main recognition in chapter 15, automatically invoking the Section 362 stay under Section 1520(a)(1) and barring enforcement of the consent judgment in the U.S.

Foreign main recognition likely would have entitled the liquidator to enforce the Singaporean court's treatment of the plaintiff's claim in the U.S. under Section 1521(a). Under the same section, the chapter 15 court might have been able to vacate the consent judgments, perhaps by issuing a report and recommendation to the district court.

To this writer, pursuing a common law remedy seems foolish when chapter 15 is available, offers a wider range of relief and is enforceable in bankruptcy courts familiar with its procedures.

The opinions are those of this writer, not ABI.

The opinion is *Vertiv Inc. v. Wayne Burt PTE Ltd.*, 22-3305 (3d Cir. Feb. 1, 2024).


***With no opposition, a mainland Chinese company with an approved arrangement in Hong Kong might win foreign main recognition in the U.S.***

# Mainland Chinese Company Wins Foreign Main Chapter 15 Recognition in New York

Bankruptcy Judge Philip Bentley of New York drew a roadmap describing how large companies operating in mainland China can obtain so-called foreign main recognition in a chapter 15 case in New York by having schemes of arrangement "sanctioned" by a court in Hong Kong.

Notably, the desired outcome may depend on whether anyone objects and whether creditors overwhelmingly endorse the Hong Kong scheme.

Prof. Jay L. Westbrook told ABI that "Judge Bentley in general has written a thoughtful and useful opinion avoiding the rubber stamp too often seen in recognition cases. Yet, it raises a concern I have about all the 'no objection' cases."

The Holding Company Debtor

Incorporated in the Cayman Islands, the debtor was a "pure" holding company for a large property developer with billions of dollars of assets in mainland China. As Judge Bentley said in his January 30 opinion, the debtor itself had few assets and no operations in Hong Kong. However, the debtor claimed to be headquartered in Hong Kong, and its stock was traded on the Hong Kong Stock Exchange.

Aside from the chief financial officer, "almost all" of the debtor's senior management were located on the mainland, Judge Bentley said.

The debtor ran into financial difficulty, and its subsidiaries defaulted on debt that was principally raised on the mainland and denominated in Chinese currency. The debtor, however, had no Chinese-denominated debt. Rather, it had about $9 billion in unsecured debt, including almost $8 billion governed by New York law and about $1 billion governed by Hong Kong law.

The debtor negotiated a restructuring support agreement endorsed by holders of 85% of the $9 billion in debt. The Hong Kong court approved the debtor's scheme of arrangement by the required super majorities. The same day, the debtor filed a chapter 15 petition in New York and sought approval of the Hong Kong proceedings as a foreign main proceeding.


There were no objections to foreign main recognition, but Judge Bentley conducted his own independent analysis.

Hong Kong Is the COMI

Section 1502(4) declares that "'foreign main proceeding' means a foreign proceeding pending in the country where the debtor has the center of its main interests." In the Second Circuit, COMI was principally defined in *Morning Mist Holdings Ltd. v. Krys (In re Fairfield Sentry Ltd.)*, 714 F.3d 127 (2d Cir. 2013). The appeals court said that COMI must be determined at the time of the chapter 15 filing and laid out factors to decide "whether the registered-office presumption has been overcome."

In the case before him, Judge Bentley said that "the Debtor conducts no business in the Caymans, has no assets or creditors there, and has no offices there except a 'mail-drop' address. In addition, the Debtor chose not to restructure in the Cayman Islands — a potentially dispositive consideration in this circuit."

With the COMI not in the Cayman Islands, Judge Bentley said that the question was whether mainland China or Hong Kong was the COMI. Quoting *Fairfield Sentry*, *id* at 130, he said that "'COMI lies where the debtor conducts its regular business, so that the place is ascertainable by third parties.'"

Analyzing the facts, Judge Bentley observed that the debtor had "no real headquarters" but only a mail drop in Hong Kong. However, he said that headquarters can also mean "nerve center."

"In this case," Judge Bentley said, "Hong Kong has always been the center of the Debtor's business activities and decision-making," pointing toward COMI in Hong Kong.

Judge Bentley discounted the fact that all corporate officers other than the CFO were on the mainland. Instead, he looked to where they made their decisions in the restructuring and concluded that "Hong Kong has always been the locus of the Debtor's activities and decision-making."

The debtor's most valuable assets, the subsidiaries, "should be deemed located [on the mainland], weighing in favor of a [mainland] COMI finding," Judge Bentley said.

The jurisdiction whose laws apply to most disputes is a factor. Although New York law governed $8 billion of the debt, Judge Bentley said that the $1 billion under Hong Kong law had "outsized significance" since Hong Kong law follows the so-called *Gibbs* rule, which says that Hong Kong debt may be restructured only in Hong Kong.

Were the restructuring on the mainland, Judge Bentley said there would have been a parallel proceeding in Hong Kong. "This factor," he said, "weighs in favor of Hong Kong as the COMI."


Judge Bentley said that the debtor's primary business activity was the "restructuring," which was led by the CFO, who resided in Hong Kong. He thus concluded that "there is little question that Hong Kong is the Debtor's COMI."

With regard to creditors' expectations, Judge Bentley said there was "little reason" for creditors to expect a restructuring in Hong Kong, but "less reason to expect a restructuring [on the mainland]."

"Given that the COMI choice in this case is not between Hong Kong and the Cayman Islands but instead between Hong Kong and the [mainland], this expectation weighs in favor of a Hong Kong COMI," Judge Bentley said.

Judge Bentley also gave "significant weight" to creditors' support for the restructuring, "particularly if no creditor objects to the debtor's choice of restructuring forum." He ruled that "the Debtor is entitled to recognition of the Hong Kong proceeding as a foreign main proceeding."

Commentary by Prof. Westbrook

Prof. Westbrook, one of the drafters of chapter 15, told ABI, "I welcome the independent examination that the court provides in this case, but I worry that the opinion does not discuss a number of other factors that a COMI analysis should include."

Prof. Westbrook explained:

> Because of the lack of an objection, there are a number of important facts about the case we aren't told. For example, given that the Hong Kong debtor had no real, economic existence, and **if** no guarantees were provided by the asset-rich subsidiaries on the mainland, did the guaranteeing subsidiaries have any accessible assets? If so, were those subsidiaries released? If yes, then the case looks somewhat like *In re Vitro S.A.B. de C.V.*, 701 F.3d 1031 (5th Cir. 2012); if not, then the creditors took their chances lending it $9 billion unsecured.

"As to the fact of no objection," Prof. Westbrook said, "there likely was resistance from creditors because the chapter 15 case would probably not have been brought if all the creditors were on board.

"As with other no-objection cases," Prof. Westbrook said, "the nondiscussion of these sorts of facts should make later courts hesitant to draw too many binding precedential conclusions despite the fine analysis."


Prof. Westbrook occupies the Benno C. Schmidt Chair of Business Law at the University of Texas School of Law and is the country's leading expert on cross-border insolvency.

The opinion is *In re Sunac Holdings Ltd.*, 23-11505 (Bankr. S.D.N.Y. Jan. 30, 2024).


*A foreign branch of a U.S. bank isn't a foreign bank eligible for chapter 15.*

# A Foreign Branch of an FDIC-Insured U.S. Bank Is Ineligible for Chapter 15

A bankruptcy proceeding abroad for a foreign "branch" of a U.S. bank isn't eligible for recognition under chapter 15, even if the banking business has terminated abroad and foreign liquidators have been appointed, for reasons explained by Bankruptcy Judge Martin Glenn of New York.

Judge Glenn was importuned to write his February 22 opinion in the wake of the insolvency of Silicon Valley Bank, which led to the appointment of the FDIC as receiver in March 2023. The bank had a branch in the Cayman Islands.

The branch was not separately incorporated. Although licensed to do business in the Caymans, the branch was prohibited from taking deposits from residents of the island. There were no officers or employees in the Caymans, only a mail drop.

The Federal Reserve exercised its discretion to declare a "systemic risk exception" allowing the FDIC to pay all depositors in full, not just the ordinary limit of $250,000 per account. The FDIC determined that deposits of $476 million at the Caymans branch were not eligible for payment from FDIC insurance. Instead, the FDIC declared that the branch's depositors would have unsecured claims in the FDIC receivership.

Realizing they would not be paid by the FDIC, some of the branch's depositors initiated winding-up proceedings in the Cayman Islands. The court in the Caymans appointed liquidators who applied for foreign main recognition in New York under chapter 15.

The FDIC opposed recognition and won.

Judge Glenn described the FDIC as having raised a "gating issue" regarding the branch's eligibility to be a chapter 15 debtor.

To the point, Section 1501(c) provides that chapter 15 "does not apply to — (1) a proceeding concerning an entity . . . identified by exclusion in section 109(b)." Of course, Section 109(b) says that a debtor under the Bankruptcy Code may not be, among other things, "a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, . . . credit union, or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act."


Citing the *Collier* treatise, Judge Glenn said, "Chapter 15 does not apply to entities that are ineligible for relief under section 109(b)." He also quoted *Collier* as saying: "[F]oreign representatives of foreign banks which are subject to foreign proceedings will not be eligible for Chapter 15 recognition if the foreign banks have a branch or agency in the United States."

In addition, Judge Glenn cited the Second Circuit for holding that Section 109 applies to chapter 15 cases.

The liquidators vied for chapter 15 recognition, contending that they were not acting as a bank and that foreign banks have been held eligible for chapter 15 recognition. Judge Glenn distinguished authorities proffered by the liquidators, saying that a case in Delaware involved an Irish bank that "did not have a branch or agency in the U.S. as required under section 109(b)(3)(B) at the time of its Chapter 15 petition filing." *In re Irish Bank Resolution Corp. Ltd.*, 538 B.R. 692 (D. Del. 2015)."

Judge Glenn said that the branch in the case before him "possessed no separate legal existence outside of the [U.S.] Bank, which was indisputably U.S.-incorporated and ineligible for bankruptcy relief pursuant to section 109(b)(2) as a domestic FDIC-insured bank."

Judge Glenn dismissed the chapter 15 petition, holding that the branch "remains, for all intents and purposes of this proceeding, what Silicon Valley Bank has always been — a bank that is ineligible to be a debtor under the Bankruptcy Code."

The opinion is *In re Silicon Valley Bank (Cayman Islands Branch)*, 24-1076 (Bankr. S.D.N.Y. Feb. 22, 2024).


***A bankruptcy judge in New York was deferential to foreign liquidators using chapter 15 to extinguish a lawsuit in the U.S. that they saw as a nuisance.***

# A 'Litigation Tactic' Isn't Fatal in Chapter 15

A decision by Bankruptcy Judge James L. Garrity, Jr., of New York shows the deference given to foreign liquidators who file a chapter 15 petition to extinguish a derivative suit in the U.S. that the liquidators labeled a "nuisance case" that was depleting the debtor's few remaining assets.

The debtor's parent company was incorporated in Bermuda. Operations were in the U.S. and Canada.

The debtor was acquired in a leveraged buyout in 2004. In 2006, the debtor repaid the buyers for the $200 million they had invested to effect the buyout. A year later, the company refinanced, took down additional debt and paid a $375 million dividend to the owners.

In 2012, 71 shareholders with less than 4% of the stock brought a derivative action in New York state court against the debtor's directors and controlling shareholders. The suit didn't go well for the plaintiffs. By 2020, the plaintiffs were on their sixth amended complaint, the prior iterations having been dismissed in whole or in part. Of course, the debtor was named as a defendant in the derivative suit.

Meanwhile, the controlling shareholders had begun a members' voluntary liquidation in 2013 in Bermuda, where the court had appointed joint liquidators. In 2019, the Bermudian court converted the case to a voluntary winding-up and retained the joint liquidators.

By 2020, with only $100,000 remaining in the administratively insolvent Bermudian estate, the liquidators filed suit in Bermuda to bar the New York plaintiffs from proceeding with the suit. The plaintiffs responded by asking the state court to enjoin the liquidators from attempting to stop the suit in Bermuda.

To bring the dispute to a head in a court with undisputed jurisdiction to decide whether the plaintiffs could proceed with the suit in state court, the liquidators filed a chapter 15 petition in New York in 2020. Judge Garrity granted so-called foreign main recognition a few months later, overruling objections from the New York plaintiffs.

In granting recognition, Judge Garrity said that foreign main recognition could be given even when the purpose of the chapter 15 filing was to enjoin the shareholders' suit in New York. In his


recognition opinion, however, he left the door open for modifying the automatic stay on motion by the plaintiffs in the New York suit. *In re Culligan Ltd.*, 20-12192, 2021 BL 250936, 2021 Bankr. Lexis 1783, 2021 WL 2787926 (Bankr. S.D.N.Y. July 2, 2021). To read ABI's report, click here.

Recognition invoked the automatic stay in Section 362, halting the suit in state court.

Responding in bankruptcy court, the plaintiffs filed a motion to lift the automatic stay to permit the suit to continue in state court and to compel the liquidators to abandon the suit to them. Judge Garrity denied the plaintiffs' motion in an opinion on September 12.

With regard to abandonment, Judge Garrity ruled that the statute contains no statutory power for creditors or shareholders to move to compel abandonment in a chapter 15 case, because Section 554 is not among the sections incorporated into chapter 15 cases by Section 103(a) or Section 1520(a). On the other hand, Section 1527(a)(7) permits a foreign representative to move for abandonment.

Even if the statute entitled the plaintiffs to move to compel abandonment, Judge Garrity cited the liquidators' belief that the suit was a "nuisance case" and that they would be "adversely impacted" by abandoning the suit to the plaintiffs and incurring fees arising from the suit.

Having rejected the request for abandonment, Judge Garrity turned to the plaintiffs' motion to modify the automatic stay.

Judge Garrity concluded that the 12 *Sonnax* factors did not favor a stay modification. Among other things, he said "it is not unreasonable for the Foreign Representatives to view the New York Action as a 'nuisance case' that is draining the limited remaining assets of the Debtor."

Having failed on *Sonnax*, the plaintiffs contended that Judge Garrity should modify the stay because the chapter 15 filing was a bad faith litigation tactic. Rejecting the bad faith argument, Judge Garrity said:

> [T]he Foreign Representatives readily admit that the chapter 15 filing is part of their strategy to enjoin, control, and eventually dismiss, an action that they view as meritless, which is draining the Debtor's limited assets and preventing the orderly completion of the Bermuda Liquidation. This strategy is not so much a tactic to combat a negative outcome in the New York Action as it is a tactic to bring the New York Action to a conclusion in furtherance of the Debtor's wind-down.

Judge Garrity said that "the Foreign Representatives 'may or may not be correct' that dismissal of the New York Action is the best course of action, [citation omitted], but for reasons outlined herein, their view is not unreasonable."


Judge Garrity denied the plaintiffs' motion to modify the stay.

The opinion is *In re Culligan Ltd.*, 20-12192 (Bankr. S.D.N.Y. Sept. 12, 2023).


***A district judge in New York reversed the bankruptcy court, which had held that a Kuwaiti public pension fund was not entitled to sovereign immunity for having engaged in commercial activity.***

# Foreign Sovereign Immunity Bars the Madoff Trustee from Recovering $20 Million

Reversing the bankruptcy court, a district judge in New York allowed a Kuwaiti public pension fund to escape liability for receipt of $20 million stolen from customers in the infamous Bernard L. Madoff Ponzi scheme.

In his September 20 opinion, District Judge Gregory H. Woods concluded that the pension fund was entitled to sovereign immunity from suit in the U.S. because the payment came from cash on hand held by one of Madoff's so-called feeder funds, not from cash that the feeder fund withdrew from Madoff in response to the pension fund's redemption request.

The appeal involved the Public Institution for Social Security, a Kuwaiti governmental agency. It began investing in Madoff in 1999 through an offshore feeder fund known as Fairfield Sentry. Substantially all investments in the feeder fund by the feeder fund's customers were in turn invested in Madoff. The Kuwaiti fund allegedly knew that its investments were going to Madoff.

When the fraud surfaced, Madoff's business was thrown into liquidation in New York in 2008 under the Securities Investor Protection Act, which incorporates large swaths of the Bankruptcy Code, including the ability to mount fraudulent transfer suits. The feeder fund went into its own liquidation abroad.

The Madoff trustee had fraudulent transfer claims against the feeder fund because the feeder fund received money stolen from customers. Because the feeder fund was largely a dry hole, the Madoff trustee sued investors in the feeder fund as subsequent transferees of fraudulent transfers.

The Kuwaiti fund was among the feeder fund customers that the Madoff trustee sued in 2012. The trustee was aiming to recover $20 million in a redemption that the Kuwaiti fund received from Fairfield Sentry in 2004. The Kuwaiti fund filed a motion to dismiss, claiming sovereign immunity under the Foreign Sovereign Immunities Act, or FSIA. The bankruptcy court denied the motion to dismiss, but Judge Woods granted leave for the Kuwaiti fund to pursue an interlocutory appeal.


The Madoff trustee conceded that the Kuwaiti fund was protected from suit in the U.S. unless the exception for "commercial activity" in FSIA were to apply under 26 U.S.C. § 1605(a)(2).

The Structure of the Redemption

The Kuwaiti agency did not receive the redemption directly from Madoff. Rather, the Kuwaiti fund sent a redemption request to the feeder fund that resulted in the $20 million payment. The redemption request came from abroad and was directed to a Fairfield Sentry agent also abroad. The $20 million emanated from a Fairfield Sentry bank account abroad and first went to a bank in New York for further credit to a bank account of the Kuwaiti fund in London.

The "critical fact," Judge Woods said, is that the $20 million redemption request "did not lead Fairfield Sentry to request money from [Madoff] in the United States. At the time of the redemption request, Fairfield Sentry was sitting on a huge amount of cash that was sufficient to permit Fairfield Sentry to fund the redemption request without making a withdrawal from [Madoff]."

Judge Woods said that the $20 million transfer to the Kuwaiti fund came about six months after Fairfield Sentry's "most recent transfer from" Madoff. Between the last transfer from Madoff and the transfer to the Kuwaiti fund, he said that "Fairfield Sentry received funds from third parties sufficient to deposit $120,000,000 with [Madoff], after giving effect to [the Kuwaiti fund's] redemption request."

The FSIA Exception

Judge Woods described the appeal as turning on the third clause in the exception to sovereign immunity contained in 26 U.S.C. § 1605(a)(2). The exception applies to a lawsuit "based . . . upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States."

The Kuwaiti fund conceded that the redemption was "commercial activity" but argued (successfully) that the act did not have "a direct effect in the United States." Citing the Second Circuit, Judge Woods said that the "direct effect" must be "legally significant."

Judge Woods rejected the Madoff trustee's contention that the relevant act was the Kuwaiti fund's initial investment in Madoff through the feeder fund. However, he cited the record as showing that the initial investment did have an effect in the U.S.

To identify the relevant "act," Judge Woods noted that the feeder fund did not request money from Madoff to cover the Kuwaiti fund's redemption request. Because the $20 million transfer from the feeder fund to the Kuwaiti fund came from one foreign entity to another, he said there was no direct effect on the U.S.


Again citing the Second Circuit, Judge Woods said:

> The possibility that the transfer transited through a New York correspondent bank on its way between the foreign bank accounts of two foreign entities does not matter — the brief transit of funds through a U.S. correspondent account is not "legally significant."

Judge Woods saw no "direct domestic effect." He said that the payments by Madoff to the feeder fund "were made five months *prior* to the redemption request that triggered the January 2004 $20 million transfer . . . . [I]t cannot be the case that [the Kuwaiti fund's] redemption request triggered any movement of funds from [Madoff] to Fairfield Sentry." [Emphasis in original.]

Judge Woods therefore held that the Madoff trustee "has not sufficiently shown that either the redemption request from [the Kuwaiti fund] to Fairfield Sentry or the $20 million transfer from Fairfield Sentry to [the Kuwaiti fund] had any direct effect on the United States."

Judge Woods reversed the bankruptcy court and granted the Kuwaiti fund's motion to dismiss.

Observations

Does the opinion by Judge Woods elevate form over substance?

Fairfield Sentry made virtually no investments aside from Madoff. The feeder fund was an instrumentality through which foreign and U.S. investors invested with Madoff and did so for a variety of reasons, such as avoiding a direct presence in the U.S., avoiding a direct investment with Madoff or channeling their investment abroad.

Funds held by the feeder fund were either investments that the investors had earmarked for Madoff or were monies coming out of Madoff. In essence, the feeder fund could be seen as an instrumentality through which Madoff fostered his Ponzi scheme worldwide.

The "huge amount of cash" to which Judge Woods referred did not emanate from the feeder fund's own astute investments elsewhere. Like any responsible fund, it maintained significant cash balances to respond quickly to redemption requests without having to await drawdowns from Madoff.

In the worst case for the Madoff trustee, the $20 million taken by the Kuwaiti fund was stolen from investors who intended to invest in Madoff. Isn't that a "direct effect" on a Ponzi scheme in the U.S.?


There likely will be an appeal, because the Madoff trustee has another suit with a different foreign sovereign involving $200 million, or 10 times the amount at issue with the Kuwaiti fund. On appeal, the Madoff trustee may be arguing that Judge Woods went beyond the complaint to grant the motion to dismiss by finding that the redemption given to the Kuwaiti fund did not come from Madoff, according to the record.

Note

The suit with the Kuwaiti fund is just now at the motion-to-dismiss stage because the suit was dismissed as a result of a decision handed down in 2014 by District Judge Jed Rakoff. *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC (In re Bernard L. Madoff Investment Securities LLC)*, 513 B.R. 222 (S.D.N.Y. 2014). The Madoff trustee persevered and won a reversal in the Second Circuit in 2019. *In re Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC*, 917 F.3d 85 (2d Cir. Feb. 25, 2019).

The Second Circuit held in 2019 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 reversal allowed the Madoff trustee to revive almost 90 avoidance actions where the trustee was pursuing the recovery of some $3.2 billion, before prejudgment interest. To read ABI's report about the Second Circuit decision, click here.

The opinions are those of the writer, not ABI.

The opinion is *Public Institution for Social Security v. Picard (In re Bernard L. Madoff Investment Securities LLC)*, 22-8741 (S.D.N.Y. Sept. 20, 2023).

# Faculty

**Hon. Kevin R. Anderson** is a U.S. Bankruptcy Judge for the District of Utah in Salt Lake City, appointed on Sept. 4, 2015. Previously, he served for 17 years as the standing chapter 13 trustee for the District of Utah, administering more than 70,000 chapter 13 cases. Judge Anderson served as president of the National Association of Chapter 13 Trustees (NACTT), and he served on several national committees regarding chapter 13 legislation, rules, forms and policy. He has frequently written and presented on chapter 13 issues, including for the *Norton Bankruptcy Law Advisor*, the *ABI Journal*, the *NACTT Quarterly* and the *NACTT Academy for Consumer Bankruptcy Education*. He also is a Fellow in the American College of Bankruptcy. Prior to his appointment as chapter 13 trustee, Judge Anderson practiced for 13 years as a commercial litigator with an emphasis on civil fraud, real property, and representing chapter 11 and 7 trustees. He also clerked for Hon. David N. Naugle, U.S. Bankruptcy Judge for the Central District of California. Prior to law school, Judge Anderson worked for two years as a data systems specialist testing military and commercial jet engines for General Electric. He received his J.D. *cum laude* from the J. Ruben Clark Law School at Brigham Young University.

**Prof. Sally McDonald Henry** is a professor of law at Texas Tech University School of Law in Lubbock, Texas, who specializes in commercial law, corporate law, banking, bankruptcy and related litigation. Before coming to Texas Tech, she practiced law for almost 30 years, first as an associate, then as a partner in the corporate restructuring department of Skadden, Arps, Slate, Meagher & Flom LLP. Prof. Henry's practice included serving as counsel for a number of debtors and creditors in high-profile cases throughout the U.S. She also served as counsel to the debtor-in-possession or trustee in oil-trading cases, retail reorganization cases, real estate development cases and commodity-trading cases, among others. In addition, Prof. Henry represented secured and unsecured creditors and distressed-asset-purchasers in numerous high-stakes matters. In addition, she counseled numerous boards of directors on mergers and acquisitions, their fiduciary duties and high-stakes transactions. In 2003, Prof. Henry won a city-wide award from the Legal Aid Society of New York for her *pro bono* work. She is the co-author of *Ordin on Contesting Confirmation* and sole author of its annual updates, the editor of the annual *Portable Bankruptcy Code* published by the American Bar Association, and numerous other books and articles. Moreover, she has lectured on corporate and cross-border debtor-creditor issues throughout the world. Prof. Henry is admitted to practice in New York and in the Southern District of New York, as well as a number of the federal courts of appeals. She received her undergraduate degree from Duke University and her J.D. from New York University School of Law, where she won a number of awards for her scholarship.

**Hon. Cathleen D. Parker** is Chief U.S. Bankruptcy Judge for the District of Wyoming in Cheyenne, appointed on June 2, 2015. Prior to her appointment, she was an attorney with the Wyoming Attorney General's Office for 16 years, where she primarily represented the Wyoming Departments of Revenue and Audit in front of administrative tribunals, the Wyoming State Courts and the Wyoming Supreme Court. At the time of her appointment, she was the supervisor of the Revenue Section of the Civil Division and was the head of the Attorney General's Bankruptcy Unit. Prior to joining the Office of the Attorney General, Judge Parker worked as an attorney in private practice in Colorado, han-

dling both civil and criminal matters. She also sits on the Tenth Circuit Bankruptcy Appellate Panel. Judge Parker received her J.D. with honors from the University of Wyoming College of Law in 1998.

**William J. Rochelle, III** is ABI's editor-at-large, based in New York. He joined ABI in 2015 and writes every day on developments in consumer and reorganization law. For the prior nine years, Mr. Rochelle was the bankruptcy columnist for Bloomberg News. Before turning to journalism, he 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, Mr. Rochelle travels the country for ABI, speaking to bar groups and professional organizations on hot topics in the turnaround community and trends in consumer bankruptcies. He earned his undergraduate and law degrees from Columbia University, where he was a Harlan Fiske Stone Scholar.

**Hon. Michael E. Romero** is a U.S. Bankruptcy Judge in the District of Colorado in Denver, initially appointed in 2003 and appointed Chief Judge from July 2014-June 2021. He is also Chief Judge of the Tenth Circuit Bankruptcy Appellate Panel. Since becoming a judge, Judge Romero has served on numerous committees and advisory groups for the Administrative Office of the U.S. Courts, is the past chair of the Bankruptcy Judges Advisory Group and has served as the sole bankruptcy court representative/observer to the Judicial Conference of the United States, the governing body for the federal judiciary. He is a past president of the National Conference of Bankruptcy Judges and actively participates in several of its committees. He also serves on the Executive Board of Our Courts, a joint activity between the Colorado Judicial Institute and the Colorado Bar Association that provides programs to further public understanding of the federal and state court systems. Judge Romero is a member of the Colorado Bar Association, ABI, the Historical Society of the Tenth Circuit and the Colorado Hispanic Bar Association. He received his undergraduate degree in economics and political science from Denver University in 1977 and his J.D. from the University of Michigan in 1980.

**Hon. Kimberley H. Tyson** is Chief U.S. Bankruptcy Judge for the District of Colorado in Denver, initially appointed to the bench in May 2017 and appointed Chief Judge in 2021. Prior to that, she was in private practice, where she concentrated in workouts, bankruptcy and related commercial litigation. From March 2011 until her appointment to the bench, Judge Tyson served as a chapter 7 trustee. She has served as the Tenth Circuit representative on the National Conference of Bankruptcy Judge's Board of Governors, and she is a member of the Colorado Bar Association's Bankruptcy Subcommittee and its former chair. Judge Tyson is an active ABI member and has served on the advisory board of its annual Rocky Mountain Bankruptcy Conference since 2003. After law school she clerked for Hon. John K. Pearson of the U.S. Bankruptcy Court for the District of Kansas and Hon. Jerry G. Elliot of the Kansas Court of Appeals. Judge Tyson received her B.A. at Smith College and her J.D. at the University of Kansas School of Law.