Bill on Bankruptcy

Circuit Splits and Other Important Developments in Bankruptcy Law

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Bill Rochelle
Editor-at-Large
American Bankruptcy Institute
bill@abi.org
(703) 894-5909
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American Bankruptcy Institute
66 Canal Center Plaza, Suite 600 • Alexandria, VA 22014 • www.abi.org

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Circuit Splits

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Third Circuit ditches an otherwise proper involuntary petition for creditors' bad faith.

Third Circuit Widens Split on Bad-Faith Dismissal of Involuntary Petition

The Third Circuit split with the Ninth and sided with the Fourth in holding that bankruptcy courts can dismiss involuntary petitions if the petitioning creditors did not file them in good faith.

The case entailed typically protracted litigation between two companies. Three related creditors won a $300,000 judgment in arbitration but were facing a lawsuit in which the alleged bankrupt was seeking $5 million. Before the lawsuit came to trial, the creditors filed an involuntary chapter 7 petition against their adversary.

At trial, the bankruptcy judge found that the petitions satisfied the tests in Section 303 for ordering relief in the involuntary case. Nonetheless, the bankruptcy judge dismissed the petition based on the petitioners' bad faith.

The bankruptcy judge found the creditors in bad faith because they were trying to frustrate the debtor's pending lawsuit and were attempting to collect the arbitration award.

The district court affirmed dismissal, and so did the Third Circuit in an Oct. 16 opinion by Circuit Judge Julio M. Fuentes.

The creditors argued unsuccessfully that the bankruptcy court "shall order relief" if the requirements of Section 303(h)(1) have been met. Judge Fuentes disagreed with the Ninth Circuit and lower courts that are "receptive to this position."

The Third Circuit's holding was buttressed by Section 303(i)(2), which permits an award of damages against creditors who file involuntary petitions in bad faith. The appeals court interpreted the section as allowing bad faith to serve as the basis for dismissal, as well as damages.

To ignore a petitioner's bad faith would "overlook the equitable nature of bankruptcy," Judge Fuentes said. He went on to observe that courts display a "dizzying array" of standards to determine whether a petition was filed in bad faith. The opinion adopts a "totality of the circumstances" test because it is the "most suitable for evaluating the myriad ways" a creditor can act in bad faith.

The case is *In re Forever Green Athletic Fields Inc.*, 14-3906 (3d Cir. Oct. 16, 2015).

Creditors, rejoice! Substantial contribution is rewarded, at least in the Sixth Circuit.

Sixth Circuit Splits with Third on Substantial Contribution in Chapter 7

The Sixth Circuit disagreed with a sister appeals court by allowing creditors in chapter 7 to have an administrative claim for a "substantial contribution," even though Section 503(b)(3)(D) only lists chapters 9 and 11 as the types of cases where they are allowed.

The Sept. 21 opinion by Circuit Judge Bernice B. Donald evidently represents the minority view. According to the dissent by Circuit Judge Kathleen M. O'Malley, the Third Circuit and at least 25 lower courts have held that a creditor's substantial contribution claim can succeed only in chapters 9 and 11.

Three creditors contributed to a chapter 7 case by initiating proceedings that resulted in removing the trustee. The substitute trustee sued the former trustee and an insurance company, resulting in a settlement characterized by the bankruptcy judge as contributing in part to a "substantial benefit" to the estate and creditors. The bankruptcy judge nonetheless denied a substantial contribution claim, saying it was not authorized by subsection (b)(3)(D).

Judge Donald reversed, beginning her analysis by saying that "equitable principles govern the exercise of bankruptcy jurisdiction." She largely based her decision on use of the word "including" before the list of administrative claims enumerated in subsection (b).

Given the use of "including," Judge Donald said Congress left the door open for courts to award administrative claims for expenses not specifically mentioned in Section 503(b)'s subsections.

The plain meaning of the subsection did not require denying the claim, Judge Donald said, because the statute nowhere says that expenses of the sort cannot be allowed in chapter 7. She also said the result was not compelled by the canon of construction known as "*expressio unis est exclusion alerius*," or the "expression of one thing excludes the other."

To Judge Donald's way of thinking, denying reimbursement "would disincentivize participation in the bankruptcy process" and "impugn the fundamental notion of bankruptcy's equitable relief."

The opinion is *Mediofactoring v. McDermott* (*In re Connolly North America LLC*), 802 F.3d 810 (6th Cir. Sept. 21, 2015).

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Gutsy Ninth Circuit BAP importunes the Supreme Court to rule on late-filed tax returns.

Ninth Circuit BAP Splits with Three Circuits on Dischargeablity of Tax Debts

The Ninth Circuit Bankruptcy Appellate Panel is trying to foment a split of circuits so the Supreme Court can decide whether a tax debt can never be discharged if the return is filed even one minute after the deadline.

So far, the Fifth, First and Tenth Circuits have all employed what Bankruptcy Judge Frank L. Kurtz, in his opinion for the Ninth Circuit appellate panel, called a literal construction of the so-called hanging paragraph added by Congress to the end of Section 523(a) in the 2005 BAPCPA amendments. In his Dec. 17 opinion, Judge Kurtz called it the "unforgiving view of congressional intent," because someone who files a late tax return can never discharge the underlying debt.

Columbia University Law Professor Ronald J. Mann attempted to take the Tenth Circuit case to the Supreme Court in 2015. The high court denied *certiorari*. Prof. Mann said that the circuit courts "ruled against the taxpayers on a ground that the Internal Revenue Service won't defend."

"Every appellate court to consider the question after BAPCPA has adopted the bright-line rule that no late filing ever can be a return," Prof. Mann told ABI. Judge Kurtz's opinion, he said, "provides a roadmap for the Ninth Circuit to reject that growing consensus. And that, in turn, would make the likelihood of Supreme Court review almost certain."

Judge Kurtz's opinion meticulously picks apart the shortcomings inherent in literal interpretation. He concludes that the hanging paragraph did not alter the two Ninth Circuit cases that adopted a version of the *Beard* test, which defines the term "return" in the context of determining nondischargeability of tax debts.

The literal approach, he said, would bar a debtor from discharging a tax debt if the return were filed even a minute late, "whereas a debtor taxpayer who never bothers to file his or her own tax return can discharge his or her associated tax debt if the IRS fortuitously prepares a tax return on that person's behalf." Judge Kurtz also points out how the IRS itself does not follow the literalist interpretation.

Judge Kurtz reversed and remanded the case for the bankruptcy judge to apply the Ninth Circuit's modified *Beard* test, which inquires into whether the document purports to be a return

that was signed under penalty of perjury, contained sufficient information to allow calculation of the tax, and was an "honest and reasonable" attempt to satisfy the requirements of tax law.

It is unclear whether Judge Kurtz's opinion is an appealable final order, because he remanded for the bankruptcy judge to perform more than ministerial functions.

The circuit court cases are *Fahey v. Massachusetts Department of Revenue (In re Fahey)*, 779 F.3d 1 (1st Cir. 2015); *In re Mallo*, 774 F.3d 1321 (10th Cir. 2014); and *McCoy v. Mississippi State Tax Commission (In re McCoy)*, 666 F.3d 924 (5th Cir. 2012).

The Ninth Circuit appellate panel opinion is *U.S. v. Martin (In re Martin)*, 14-1180 (B.A.P. 9th Cir. Dec. 17, 2015).

Long Island's Judge Trust becomes a savior for company executives.

Bullock Applied to Absolve Officers from Nondischargeable Debts

Bankruptcy Judge Alan S. Trust from Central Islip, N.Y., swam against the tide in his own circuit when he weighed in on a split among the appeals courts by holding that a controlling company officer does not commit a "defalcation while acting in a fiduciary capacity" when the company fails to make a contribution to an employee benefit fund.

Courts have reached differing conclusions depending on how a particular union agreement is written. If plan assets include payments that should have been made but were not, some judges rule that there is a breach of fiduciary duty resulting in a nondischargeable debt under Section 523(a)(4).

If the plan does not purport to include unmade contributions among its assets, other courts will find no breach of fiduciary duty and exonerate a company officer from being saddled with a nondischargeable debt.

The split boils down like this. The Second and Eleventh Circuits recognize exceptions to the general rule by saying there is a fiduciary duty if unpaid contributions are deemed assets of the plan. The Tenth and Sixth Circuits take the opposite view and find no violation of a fiduciary duty, even when unpaid contributions are plan assets.

In a case called *Bos v. Board of Trustees,* the Ninth Circuit was the appeals court to tackle the issue most recently. In late July, that court found no violation of a fiduciary duty, even when unpaid contributions were plan assets.

Principally, the circuit court said in *Bos* held that an unpaid contribution was merely an account receivable for the plan. Since the business owner did not control the ability to collect the receivable, he committed no violation of a fiduciary duty.

Judge Trust used a different approach.

In his case, decided on Dec. 10, the plan purported to convert contributions into plan assets whether they were made or not. Although Judge Trust found most of the prerequisites for a violation of Section 523(a)(4), he held that the controlling company officer did not engage in "intentional wrong or reckless conduct rising to the level of criminally wrong" as required by the Supreme Court's 2013 *Bullock* decision.

Judge Trust found no provision in the Employee Retirement Income Security Act calling for general corporate funds to be treated as trust funds. Were it otherwise, Judge Trust said, claims of the fund would be elevated above claims of secured creditors.

Treating unmade contributions as trust funds, according to Judge Trust, would put a company officer in the untenable position of deciding between nondischargeable exposure to personal liability to the fund or violating a secured creditor's rights in accounts receivable and proceeds.

Ultimately, Judge Trust held that the company officer was a fiduciary, but he "did not commit a defalcation under the *Bullock* standard." He buttressed his opinion by remarking that the record had no evidence of self-dealing, bad faith, moral turpitude or "other immoral conduct."

Judge Trust's opinion does not cite the Second Circuit's 2009 decision in *Rahm v. Halpin* (*In re Halpin*), in which the appeals court speculated that a plan could designate unpaid contributions as plan assets. In *Halpin*, the Second Circuit ultimately concluded that the plan at issue did not convert unpaid contributions into plan assets.

Although *Halpin* points in the direction of finding nondischargeability, it did not require that result in Judge Trust's case. Foremost, *Bullock* was decided later and established the standard for fiduciary conduct under Section 523(a)(4). Second, even if *Halpin*'s *dicta* were binding, Judge Trust reached his result on a different issue. As with *Bos*, he found no violation of fiduciary duty.

The opinion is *Sheet Metal Workers' National Pension Fund v. Kern (In re Kern)*, 13-8096 (Bankr. E.D.N.Y. Dec. 10, 2015).

Sixth Circuit is stricter than the Fifth when a suit violates the stay.

Suit in Violation of the Stay Must Be Dismissed

Hon. Amul R. Thapar, a district judge in Covington, Ky., pointed out the significance of a split between the Sixth and Fifth Circuits on the effect of an order lifting the automatic stay by permitting a lawsuit to proceed.

A creditor filed a lawsuit not knowing that the defendant was in bankruptcy. After receiving notice of the stay, the creditor filed a motion to modify the stay. When the bankruptcy judge lifted the stay, the creditor filed a second suit in Judge Thapar's court. The first-filed suit was removed to Judge Thapar's court, alongside the second complaint.

Judge Thapar dismissed both.

In the Sixth Circuit, where Kentucky resides, a suit in violation of the stay must be dismissed, Judge Thapar said, absent "limited equitable circumstances."

The creditor relied on the Fifth Circuit's *Sikes v. Global Marine Inc.* for the proposition that the bankruptcy judge intended to validate the filing of the original complaint in modifying the stay. Judge Thapar said the Sixth Circuit considered and rejected *Sikes*, "to define the equitable exception more narrowly."

Finding no equitable exception, Judge Thapar dismissed the first suit. He also dismissed the second suit because the statute of limitations had lapsed before it was filed. The creditor could not take advantage of Section 108(c)(2) because the second suit was filed more than 30 days after the stay was lifted.

Judge Thapar is the first South Asian to become an Article III judge. Born in Detroit, Judge Thapar was elevated to the bench in 2007.

The opinion is *Cox v. Specialty Vehicle Solutions LLC*, 15-80 (E.D. Ky. Nov. 18, 2015).

The Ninth Circuit provides another reason to avoid reorganizing on the west coast.

Ninth Circuit Won't Protect Purchasers with Equitable Mootness

The Ninth Circuit is now more firmly ensconced as a jurisdiction an investor should avoid when bent on buying a company through chapter 11.

In July, a three-judge panel held 2-1 that a buyer who actively participates in reorganization is not an innocent third party protected by the doctrine of equitable mootness, a judge-made rule of law allowing dismissal of an appeal without reaching the merits.

The reorganized company filed a motion for panel rehearing and rehearing *en banc*. The original three-judge panel withdrew its July opinion and issued a new opinion on Sept. 15, reaching the same result by the same rationale and by the same 2-1 vote. The revised opinion only made matters worse for investors arguing in the future in the Ninth Circuit that a confirmation appeal is moot after consummation of a plan.

The circuit nailed the coffin shut on Oct. 23 by denying the motion for *en banc* rehearing. No judge even sought a vote regarding *en banc* rehearing. Some debtors already avoid reorganizing in the Ninth Circuit because that court categorically precludes third-party releases.

The case involved a real estate project in which the lender exercised its option under Section 1111(b) of the Bankruptcy Code to keep the full amount of its lien on the property with an agreed value of $92 million. The due-on-sale clause in the mortgage, coupled with the election, would ordinarily mean that the lender could collect all sale proceeds were the property to be sold after emergence from chapter 11 because the claim was several times the value of the project.

The plan was confirmed over the lender's objection. It provided that the lender would not receive all sale proceeds that were the project sold between the fifth and fifteenth years after confirmation. The plan was sponsored by a purchaser who was committed to investing $30 million in the property after bankruptcy.

The lender quickly, though unsuccessfully, sought stays of the confirmation order in both the bankruptcy court and the district court. After the district court denied a stay pending appeal, the judge dismissed the appeal on the ground of equitable mootness. The lender was contesting the 10-year hole in the due-on-sale clause.

The lender appealed to the circuit and won in a revised panel opinion on Sept. 15. Writing the opinion for the majority, Circuit Judge Michelle T. Friedland reinstated the appeal and sent it back to the district court to consider the merits and decide how to modify the plan if the lender succeeded in overturning the confirmation order. Because the buyer had already invested to upgrade the property, Judge Friedland said that relief on appeal could be less than reinstatement of the entire due-on-sale clause.

Judge Friedland said the purchaser, despite its obligation to invest $30 million, is not "the type of an innocent third party that the equitable mootness doctrine is meant to protect" because the buyer participated "at every stage of these proceedings."

Citing the Fifth Circuit's 2009 opinion in *Pacific Lumber*, Judge Friedland said that "appellate consequences are foreseeable" when a sophisticated investor crafts a plan that "presses the limits" of bankruptcy law.

Judge Friedland declined to adopt a presumption, used by other circuit courts, that a plan is moot once implemented.

Circuit Judge Milan Dale Smith Jr. dissented, saying the result was "grossly inequitable." He believes the majority's opinion "discourages potential investors from relying on the finality of bankruptcy court confirmation orders."

The majority's new opinion corrected a mistake in the original July decision, in which the appeals court had said that the investor was a party to the circuit court appeal. Even though it did not participate in the appeal, the majority said the investor still was not an innocent third party protected by equitable mootness, in part because it went ahead with plan confirmation in the face of the lender's objection.

The opinion is *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc.* (*In re Transwest Resort Properties Inc.*), 12-17176 (9th Cir. Sept. 15, 2015).

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The Ninth Circuit quickly rectifies its own mistake by allowing creditors to recover counsel fees in suits to recover.

Ninth Circuit Overrules *Sternberg* to Allow Fees for Stay Violation Damage

There is no longer a split among the circuits on the ability of a debtor to recover attorneys' fees in pursuit of damages for willful violation of the automatic stay.

In a 2010 decision called *Sternberg*, the Ninth Circuit held that counsel fees could be recovered under Section 362(k) only to remedy a violation of the automatic stay and not for attorneys' fees incurred pursuing damages against the offending creditor.

Sitting *en banc*, the circuit overruled *Sternberg* with a split decision on Oct. 14 in a case called *America's Servicing Co. v. Schwartz-Tallard* (*In re Schwartz-Tallard*).

In *Sternberg*, the stay violation had been remedied before the bankrupt sued to recover damages. The appeals court concluded in its 2010 opinion that the fees could not be recovered for seeking damages, only for halting the stay violation itself.

In *Schwartz-Tallard*, a lender foreclosed on a home, knowing the homeowner was in bankruptcy. Immediately after the bankruptcy court directed that it be done, the lender reconveyed the home. The bankruptcy court awarded damages for a stay violation and ordered reconveyance of the home.

The lender unsuccessfully appealed both the grant of fees and the underlying finding of a stay violation. The bankruptcy court denied recovery of fees for the bankrupt's appeal, interpreting *Sternberg*. The bankruptcy appellate panel ruled on appeal that fees should be paid.

The first time *Schwartz-Tallard* went to the circuit court, a majority upheld the appellate panel, distinguishing *Sternberg* because the lender in the new case still contended on appeal that there was no stay violation and no need to reconvey the home. The panel opinion held last year that the "plain language" of the statute required an award of fees because the creditor had not acceded to the existence of a stay violation.

Following *en banc* rehearing, Circuit Judge Paul J. Watford wrote for the majority and noted that *Sternberg* had been subjected to "widespread criticism." Rather than examine the narrow holding of the three-judge panel, Judge Watford said that the "better course is to jettison *Sternberg*'s erroneous interpretation of Section 362(k) altogether."

Judge Watford overruled *Sternberg* because he said it "misconstrued the plain meaning of Section 362(k)." He found nothing in the statute to suggest that Congress intended to create two categories such that fees for ending the stay are recoverable while those in pursuit of damages are not.

Although Judge Watford said the subsection is not ambiguous, it was still "easy" to overrule *Sternberg*, he said, even in the absence of legislative history regarding Section 362(k). Embedded within the subsection, he found that Congress intended "to encourage injured debtors to bring suit to vindicate their statutory right to automatic stay protection, one of the most important rights afforded to debtors."

Circuit Judges Carlos T. Bea and Diarmuid F. O'Scannlain concurred in the judgment because the majority found the statute unambiguous. They declined to "engage in pure speculation" about the intent of Congress.

Circuit Judge Sandra S. Ikuta dissented. She could not find intent by Congress to "abrogate the American Rule," where each party bears its own costs. She relied in part on this year's Supreme Court decision in *Baker Botts LLP v. Asarco LLC*, in which a majority required a high level of statutory clarity before finding a modification of the American Rule.

The opinion is *America's Servicing Co. v. Schwartz-Tallard* (*In re Schwartz-Tallard*), 12-60052 (9th Cir. Oct. 14, 2015).

Chapter 11

Priority creditors beware: The Third Circuit approves both structured dismissals and gift plans.

Third Circuit Gift Plans Are Ok Because No Estate Property Is Involved

The Third Circuit sanctions both structured dismissals and gift plans.

Structured dismissals were approved in the appeals court in May by a divided panel writing about the aborted reorganization of Jevic Holding Corp. In a structured dismissal, the chapter 11 case is dismissed, but property is not distributed in accord with priorities in the Bankruptcy Code.

Unanimously, the appeals court approved gift plans on Sept. 14 when Circuit Judge Thomas Ambro wrote the opinion upholding a settlement in the attempted reorganization of LCI Holding Co. In a gift plan, the secured lender makes a payment with its own money directly to unsecured creditors, even though creditors with higher priority go unpaid.

Judge Ambro, who was a bankruptcy lawyer before ascending to the bench in 2000, reviewed a case in which the secured lender bought all of the debtor's property in a credit bid, exchanging $320 million of its $355 million in secured debt for title to the assets.

To settle the unsecured creditors' committee's objection to the sale, the buyer agreed to put its money in escrow to cover professional fees alongside an additional $3.5 million of its money earmarked exclusively for unsecured creditors. The U.S. government objected, citing its $24 million administrative tax claim arising from the sale of the property.

The government contended that the money in escrow could not be distributed in violation of the Code's priorities. The Delaware bankruptcy judge disagreed and approved the sale. A Delaware district judge affirmed in March 2014. The government went to the Third Circuit, held oral argument on the same day in January as Jevic, and lost again.

Before addressing the gift question, Judge Ambro first held that the appeal was not moot despite Section 363(m), which precludes setting aside a sale when there was no stay pending appeal. Judge Ambro said that section only protects a good faith purchase from having the sale clawed back, adding that Section 363(m) does not moot every term in a sale agreement.

Proceeding to the merits, Judge Ambro reasoned that the $3.5 million never became property of the estate and thus was eligible for distribution contrary to the rules of priority.

Although he said that the money for professional fees presented a more difficult question, he similarly concluded that the money never was and never became estate property.

Judge Ambro did not reach the question of whether priority rules apply to sales of property as opposed to chapter 11 plans. Even if priorities did apply, the settlement was proper because the money was not estate property.

The opinion does not deal with the argument that the creditors' committee was settling a claim against the lender that was estate property, thus turning settlement proceeds into property of the estate. The *LCI* opinion does not cite *Jevic*.

The opinion is *In re LCI Holding Co.*, 802 F.3d 547 (3d Cir. Sept. 14, 2015).

Bankrupt employers get a boost from the Third Circuit for negotiations with labor unions.

Expired Union Contract Can Be Rejected, Third Circuit Holds in Trump Chapter 11

Labor unions lost a major battle when the Third Circuit held that the bankruptcy court retains power to reject a labor contract even after it expired by its own terms.

The Third Circuit was the first appeals court to decide the issue. Lower courts are split. The debtor-friendly opinion on Jan. 15 is yet another reason for companies to file for reorganization in Delaware because the Philadelphia-based Third Circuit makes law for that district.

Rather than a tortured parsing of the statutory language to arrive at a result, the Third Circuit's opinion is a refreshing exercise in finding the best answer by focusing on the purpose of the law, since that Congress may not have had the precise facts in mind when adopting the statute.

The appeal arose from the reorganization of two casinos in Atlantic City, New Jersey, owned by Trump Entertainment Resorts Inc. Unite Here Local 54 wanted the Third Circuit to reverse an October 2014 decision by Bankruptcy Judge Kevin Gross in Delaware who sided with the casino operator and held there was power to reduce wages or benefits in expired contracts. Judge Gross allowed a direct appeal to the circuit.

In the *Hostess Brands Inc*. reorganization, Bankruptcy Judge Robert Drain from White Plains, New York, held in 2012 that power to terminate a collective bargaining agreement ends when the contract expires. Bankruptcy Judge Donald H. Steckroth from Newark, New Jersey, reached the same result as Judge Gross in a case called *710 Long Ridge Road*.

In her opinion deciding the Trump appeal in favor of the debtor, Circuit Judge Jane R. Roth said she would "not embark, as the parties do, on a hyper-technical parsing of the words and phrases that comprise Section 1113," the provisions in the Bankruptcy Code that govern rejection of labor contracts. Instead, she focused on the objectives of chapter 11 and the intent of Congress in adopting Section 1113 to overrule the Supreme Court's *Bildisco* decision.

The union argued that the expiration of a collective bargaining agreement meant there was no longer any contract in existence and thus nothing to reject. Were the union correct, the National Labor Relations Act would kick in, compelling the company to continue operating under the expired contract until NLRB declared an impasse in negotiations on a new contract.

Judge Roth noted that Section 1113 does not restrict its application to an executory contract. She went on to find that Congress intended "to incorporate expired collective bargaining agreements into the language of Section 1113."

She also held that allowing rejection of an expired contract is "consistent with the purpose of the Bankruptcy Code." Not allowing rejection, she said, "would impede that overriding goal" and "undercut the rehabilitative function of chapter 11."

Where bankruptcy courts can move quickly to modify union contracts when a company's survival is at stake, the NLRB can be slow to declare an impasse and thus allow an employer to impose new terms of employment. Judge Roth's opinion therefore gives a corporate debtor an important weapon for use against a labor union reluctant to grant concessions.

If expired contracts were beyond the reach of the bankruptcy court, some insolvent companies might be unable to survive the additional time required for NLRB proceedings and thus could be pressured into giving workers more than they might get under Section 1113.

Despite the Third Circuit's decisions, workers are not bereft of all power, because they can still determine whether a bankrupt company survives. Except for airline and railroad employees who cannot strike even if their wages are reduced, workers in other industries are at liberty to shut a company down if they dislike the wages imposed by the bankruptcy court.

Trump Entertainment filed for chapter 11 protection in Sept. 2014, seeking immediate relief from the labor contract at the 2,000-room Trump Taj Mahal. Its 906-room Trump Plaza had already closed. Carl Icahn, the dominant holder of $285.6 million in first-lien notes, aimed to buy the properties in exchange for debt, although only if labor and benefit costs were reduced.

The company confirmed a chapter 11 plan in March 2015. Consummation of the plan will not occur until rejection of the union contract is final.

The opinion is *In re Trump Entertaiment Resorts Inc.*, 14-4807 (3d. Cir. Jan. 15, 2016).

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Delaware became less hospitable for debtors following the Third Circuit's opinion on stays pending appeal.

Third Circuit Enhances Appellants' Rights for Stays Pending Appeal

The Third Circuit belatedly wrote an opinion in the *Revel* casino reorganization to clarify the standards for issuing a stay pending appeal. The decision also makes law on the definition of "bona fide dispute," the showing that is required before property can be sold free of an interest under Section 363(f).

In addition, the Sept. 30 opinion by Circuit Judge Thomas Ambro expanded the notion of a final order giving a right of appeal. Judge Ambro was a bankruptcy lawyer before taking the circuit bench in 2000.

In chapter 11 a second time, the Revel casino cost $2.4 billion to build and was sold this year for a disappointing $82 million. The sale motion sought authority to sell the facility free and clear of the lease of a tenant that operated two nightclubs.

The lease was unusual because the tenant contributed $16 million toward $80 million in construction costs. There was no fixed rent; instead, the tenant paid a percentage of its revenue.

Revel convinced the bankruptcy judge that the power to sell free and clear trumped a tenant's rights under Section 365(h)(1)(A)(ii) to remain in possession after rejection of the lease.

Rejecting another tenant argument, the bankruptcy judge decided that there was a bona fide dispute over the validity of the lease, allowing sale of the property free of the lease under Section 363(f).

The bankruptcy judge and a district judge both denied the tenant's application for a stay pending appeal. In a terse order on Feb. 6, the Third Circuit granted a stay, but only to the extent that Revel could not evict the tenant. Otherwise, the appeals court allowed the sale to proceed in a 2/1 order. Despite Revel's argument that any stay would crater the sale, the purchaser later decided to close the deal despite the stay.

Again for a 2/1 majority, Judge Ambro wrote a 41-page opinion on Sept. 30 to explain why the circuit granted the stay in February and to clarify how courts should balance the four factors to determine whether an appellant is entitled to a stay pending appeal. The four issues are: (1) the appellant's likelihood of success on appeal; (2) whether the appellant will suffer irreparable harm

without a stay; (3) the harm to other parties from a stay; and (4) whether a stay is in the public interest.

Judge Ambro said that factors 1 and 2 are the most important. On likelihood of success, he said the appellant must show "a reasonable chance, or probability, of winning." However, the appellant is not required to establish that winning is "more likely than not."

On irreparable harm, Judge Ambro said that the appellant must show "more than a mere possibility." He said the court must evaluate the first two factors on a sliding scale. The more likely the appellant is to win, the less heavily the balance of harms must weigh in its favor, he held.

If the appellant does not prevail on the first two factors, Judge Ambro ruled that the last two factors do not matter "and the stay should be denied without further analysis."

Applying the first two factors to the *Revel* case, Judge Ambro made law on Section 363(f)(4), which allows selling free and clear if there is a bona fide dispute over the validity of an interest in property.

Revel claimed there was a bona fide dispute regarding its contention that the lease was not a "true lease," but rather some sort of a joint venture or profit-sharing arrangement. To buttress the argument, Revel pointed to the adversary proceeding that the tenant filed for a judgment declaring that the lease was a true lease. The initiation of the suit by itself demonstrated the existence of a bona fide dispute, according to Revel's argument.

Although the two lower courts bought Revel's theory, Judge Ambro did not. He said that "Revel failed to cite a single authority suggesting that a percentage-lease clause disqualifies a purported lease from being one." He also quoted the lease itself, which said it could not be construed to create a partnership or joint venture. He characterized Revel's argument as "fanciful if not disingenuous."

Circuit Judge Patty Shwartz dissented. To win a stay, she interpreted Third Circuit law as requiring the appellant to prevail on all four elements. She also argued that the "sliding scale approach" is contrary to Third Circuit law.

In his prevailing opinion, Judge Ambro said his court had "explicitly disavowed" the notion that an appellant must prevail on all four factors. To require winning across the board would be "deeply unfair," he said.

Judge Ambro faulted Judge Shwartz for relying on later Third Circuit opinions that differed from authorities he cited. If there is a conflict, Judge Ambro said, "the earlier is controlling authority and the latter is ineffective as precedent."

Of perhaps equal importance, Judge Ambro held there was appellate jurisdiction despite Revel's argument that denial of a stay pending appeal was not a final order.

Judge Ambro conceded that denial of a stay pending appeal "is not technically a final judgment." In a "practical sense," he said, it was final because Section 363(m) would have prevented the court from later reaching the merits if there were no stay.

The ruling on finality is arguably at odds with the Supreme Court's decision this year in *Bullard*, which limits the definition of "finality" in the context of an order denying confirmation of a chapter 13 plan.

The *Revel* opinion is also arguably in conflict with the Second Circuit's terse ruling last year following confirmation of a chapter 11 plan by MPM Silicones LLC. Creditors went to the circuit court after they were denied stays pending appeal in both the bankruptcy court and the district court. In a terse, unreported opinion on Oct. 31, 2014, the New York circuit court dismissed the application for a stay pending appeal, saying the creditors "have not shown that the district court's order denying a stay should be treated as a denial of injunctive relief."

The Third Circuit opinion is *In re Revel AC Inc.*, 802 F.3d 558 (3d Cir. Sept. 30, 2015). The Second Circuit case is *BOKF NA v. Momentive Performance Materials Inc.* (*In re MPM Silicones LLC*), 14-3531 (2d Cir. Oct. 31, 2014).

Posner singlehandedly turns Chicago into a more desirable forum for large chapter 11s.

Seventh Circuit Lays Down an Easy Standard for Enjoining Suits Against Third Parties

Addressing what he called the "immense and immensely complicated" reorganization of casino giant Caesars Entertainment Operating Co. Inc., Seventh Circuit Judge Richard A. Posner penned an important opinion on Dec. 23 reversing the lower courts and establishing an easily satisfied test allowing the bankruptcy court to enjoin lawsuits in other courts against nondebtor third parties, including nonbankrupt affiliates.

Junior bondholders had filed four lawsuits in Delaware state court and a Manhattan federal district court seeking to reinstate the nonbankrupt parent's guarantees of the noteholders' bonds. The guarantees had been extinguished in two transactions in 2014 before the casino operating company filed for reorganization.

Upheld in district court in October, the bankruptcy judge had concluded in July that he lacked the power to enjoin the junior bondholders' suits against the nonbankrupt parent. The bankruptcy judge believed that Seventh Circuit precedent permitted injunctions halting suits by creditors against nonbankrupts only when the creditors were suing on claims also available to the debtors.

In reporting the district court opinion, we noted that Judge Posner was on the panel that heard the appeal on Dec. 10. We said it was "a safe bet that Judge Posner will write the circuit's opinion, because he seldom misses a chance to make a significant pronouncement on bankruptcy."

That is exactly what happened. Judge Posner said the lower courts misinterpreted the circuit's precedents in 1998 and 2009, called *Fisher* and *Teknek*, respectively. To justify an injunction halting suit against a nonbankrupt third party, he established a two-part test.

First, the bankruptcy judge must decide whether an injunction "is likely to enhance the prospects for a successful resolution of the disputes attending its bankruptcy." Second, the court has power to enjoin under Section 105(a) if denial would "endanger the success of the bankruptcy proceedings."

Although Judge Posner said he was not compelling the bankruptcy judge to issue an injunction on remand, he all but told the lower court how to rule. He said the interests of the operating company's creditors would be "furthered" by an injunction if the bondholders' suits

outside of bankruptcy court would drain the nonbankrupt parent of capital, leaving "much less money" for other creditors to recover in bankruptcy.

In that regard, Judge Posner seems to have bought into the debtor's argument that the suits, if not enjoined, might enable the bondholders to "jump the line in front of other creditors, including more senior ones."

Defeating the injunction on remand is not an impossible dream for the bondholders, however.

Since the suits in New York are near conclusion, the bondholders can argue that the Manhattan district judge should be permitted to rule on the legality of cancelling the guarantees, with the understanding that an injunction would then kick in, preventing the bondholders from exercising remedies against the nonbankrupt parent.

Even in the absence of an injunction, a judgment in New York reinstating the guarantees would not by itself enable the bondholders to "jump the line" because the parent could then file under chapter 11, putting the bondholders on the same footing as other unsecured creditors.

Judge Posner said that *Fisher* and *Teknek* had more "clear-cut" facts permitting injunctions. Those cases, he said, did not mean that a "less clear-cut case is necessarily beyond the reach of section 105(a)."

The opinion is *Caesars Entertainment Operating Co. Inc. v. BOKF NA (In re Caesars Entertainment Operating Co. Inc.)*, 15-3259 (7th Cir. Dec. 23 2015).

Posner pens a gem warning banks about ignoring signs of fraud.

Seventh Circuit Reverses District Court Again, Lowering Standard for 'Inquiry Notice'

The Seventh Circuit is no safe haven for banks holding information that should lead them to suspect that their customers are up to no good.

Circuit Judge Richard A. Posner reversed a Chicago district judge a second time in the chapter 11 liquidation of Sentinel Management Group Inc., a money manager that improperly used customers' supposedly segregated funds for its own trading. When the case returned to the Seventh Circuit in August 2013 on a motion for rehearing *en banc*, a different three-judge panel reversed, saying the trustee "should be able" to void the bank's lien and recover $312 million paid on a loan.

On remand, District Judge James B. Zagel did not take the hint. In an opinion in December 2014, he once again upheld the security interest, despite evidence that the bank suspected fraud was afoot. Reversing again in an opinion on Jan. 8, Judge Posner said that "the first panel's opinion may have been unduly deferential in remanding this issue rather than reversing outright."

The case is about "inquiry notice" and the consequences of ignoring red flags. In the Seventh Circuit, mere negligence in failing to inquire into possible fraud can result in the loss of a bank's security interest.

Sentinel provided cash-management services and promised customers that their funds would be segregated. Using a secured line of credit with a bank, Sentinel traded for its own account. Following market reverses in 2007, Sentinel began improperly taking customer funds to use as collateral for its own bank loan. After Sentinel filed under chapter 11 in August 2007, the bank had a secured claim for $312 million, collateralized by money that should have been segregated for customers. Sentinel sought a trustee four days after the chapter 11 filing.

Pursuant to Sentinel's chapter 11 plan, the trustee sued the bank in district court to void the security interest and subordinate the bank's debt. The trustee contended that transferring customer funds to the bank was a fraudulent transfer with "actual intent" under Section 548(a)(1)(A). The bank could retain the collateral if it was in "good faith" as required by Section 548(c), Judge Posner said.

After a lengthy trial, District Judge Zagel exonerated the bank, saying that an attempt to "stay in business" by stealing from one creditor to pay another represented a motive not constituting

intent to defraud. Writing for the appeals court on the first appeal, Circuit Judge John D. Tinder said that "someone who has the best intentions can still possess actual intent to defraud."

Sending the case back to the district court on remand, Judge Tinder said the bank could raise defenses, such as having made the loan to Sentinel in good faith. He also said the so-called good-faith defense is unavailable to someone with "sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency."

Judge Tinder went on to add that the bank "will have a very difficult time proving that it was not on inquiry notice of Sentinel's possible insolvency."

On remand, District Judge Zagel stuck by his guns and let the bank off the hook a second time. When the case came up again, Circuit Judge Posner said that Judge Zagel misunderstood "the concept of inquiry notice." Establishing an objective standard, he said that inquiry notice "is not knowledge of fraud or other wrongdoing but merely knowledge that would lead a reasonable, law-abiding person to inquire further."

The damning evidence was a banker's message to a subordinate asking whether the bank had rights to the collateral and how Sentinel could post $300 million when it only had $20 million in capital. The banker got an evasive answer from the underling, and the inquiry went no further.

That "puzzlement," according to Judge Posner, was enough to put the bank on inquiry notice. He went on to say that "knowing or turning a blind eye" to misconduct would make the bank guilty of fraud "but was not required to establish inquiry notice."

Although the bank lost on the fraudulent transfer question, thus voiding its security interest, the second question on appeal dealt with equitable subordination, which the bank won. On that issue, Judge Posner upheld the district court, allowing the bank to retain an unsecured claim for $312 million.

Judge Posner said that reason to suspect wrongdoing is negligent, but negligence is not enough for equitable subordination, which requires conduct that is egregious or tantamount to fraud.

The opinion rejected two other defenses proffered by the bank. Judge Posner said that Section 550(b)(1) does not apply because voiding a lien is not the same as recovering an asset. He also barred the use of Section 550(d) because there was no double recovery by the trustee.

The Sentinel appeals hint at intrigue behind the scenes in the Seventh Circuit. The first time the case came up on appeal, the original three-judge panel upheld Judge Zagel in August 2012. After the trustee filed a motion for rehearing *en banc*, the three judges withdrew their first opinion, reversed, and remanded in August 2013, as described above. One wonders whether

other judges on the circuit suggested to the original panel that they should reconsider to avoid a reversal *en banc*.

The Jan. 8 opinion is noteworthy because Circuit Judge Frank Easterbrook was on the panel. Judges Posner and Easterbrook often author the Seventh Circuit's most important bankruptcy opinions. Only Circuit Judge Ilana D. Rovner was on both panels.

The opinion is *Grede v. Bank of New York Mellon Corp.*, 15-1039 (7th Cir. Jan. 8, 2016).

The Ninth Circuit provides another reason to avoid reorganizing on the west coast.

Ninth Circuit Won't Protect Purchasers with Equitable Mootness

The Ninth Circuit is now more firmly ensconced as a jurisdiction an investor should avoid when bent on buying a company through chapter 11.

In July, a three-judge panel held 2-1 that a buyer who actively participates in reorganization is not an innocent third party protected by the doctrine of equitable mootness, a judge-made rule of law allowing dismissal of an appeal without reaching the merits.

The reorganized company filed a motion for panel rehearing and rehearing *en banc*. The original three-judge panel withdrew its July opinion and issued a new opinion on Sept. 15, reaching the same result by the same rationale and by the same 2-1 vote. The revised opinion only made matters worse for investors arguing in the future in the Ninth Circuit that a confirmation appeal is moot after consummation of a plan.

The circuit nailed the coffin shut on Oct. 23 by denying the motion for *en banc* rehearing. No judge even sought a vote regarding *en banc* rehearing. Some debtors already avoid reorganizing in the Ninth Circuit because that court categorically precludes third-party releases.

The case involved a real estate project in which the lender exercised its option under Section 1111(b) of the Bankruptcy Code to keep the full amount of its lien on the property with an agreed value of $92 million. The due-on-sale clause in the mortgage, coupled with the election, would ordinarily mean that the lender could collect all sale proceeds were the property to be sold after emergence from chapter 11 because the claim was several times the value of the project.

The plan was confirmed over the lender's objection. It provided that the lender would not receive all sale proceeds that were the project sold between the fifth and fifteenth years after confirmation. The plan was sponsored by a purchaser who was committed to investing $30 million in the property after bankruptcy.

The lender quickly, though unsuccessfully, sought stays of the confirmation order in both the bankruptcy court and the district court. After the district court denied a stay pending appeal, the judge dismissed the appeal on the ground of equitable mootness. The lender was contesting the 10-year hole in the due-on-sale clause.

The lender appealed to the circuit and won in a revised panel opinion on Sept. 15. Writing the opinion for the majority, Circuit Judge Michelle T. Friedland reinstated the appeal and sent it back to the district court to consider the merits and decide how to modify the plan if the lender succeeded in overturning the confirmation order. Because the buyer had already invested to upgrade the property, Judge Friedland said that relief on appeal could be less than reinstatement of the entire due-on-sale clause.

Judge Friedland said the purchaser, despite its obligation to invest $30 million, is not "the type of an innocent third party that the equitable mootness doctrine is meant to protect" because the buyer participated "at every stage of these proceedings."

Citing the Fifth Circuit's 2009 opinion in *Pacific Lumber*, Judge Friedland said that "appellate consequences are foreseeable" when a sophisticated investor crafts a plan that "presses the limits" of bankruptcy law.

Judge Friedland declined to adopt a presumption, used by other circuit courts, that a plan is moot once implemented.

Circuit Judge Milan Dale Smith Jr. dissented, saying the result was "grossly inequitable." He believes the majority's opinion "discourages potential investors from relying on the finality of bankruptcy court confirmation orders."

The majority's new opinion corrected a mistake in the original July decision, in which the appeals court had said that the investor was a party to the circuit court appeal. Even though it did not participate in the appeal, the majority said the investor still was not an innocent third party protected by equitable mootness, in part because it went ahead with plan confirmation in the face of the lender's objection.

The opinion is *JPMCC 2007-C1 Grasslawn Lodging LLC v. Transwest Resort Properties Inc.* (*In re Transwest Resort Properties Inc.*), 12-17176 (9th Cir. Sept. 15, 2015).

American Bankruptcy Institute
Bill on Bankruptcy

Independent board committees aren't so independent after bankruptcy.

Independent Board Committee Loses Attorney/Client Privilege with Trustee's Appointment

An independent audit committee cannot assert the attorney/client privilege when a liquidator is appointed abroad and initiates Rule 2004 discovery in the U.S. under chapter 15.

The principle established in a Sept. 30 opinion by District Judge Ronnie Abrams in Manhattan evidently would apply to a company in chapter 7, precluding an audit committee from asserting the privilege because a trustee is appointed automatically.

Likewise, it would seem that an audit committee would lose the privilege if a trustee has been appointed in chapter 11. It is unclear whether a debtor-in-possession in chapter 11 could override an audit committee's assertion of the privilege by invoking Judge Abrams' holding, at least in circumstances where pre-bankruptcy management retains control.

Judge Abrams' opinion, reversing the bankruptcy court, resulted from chapter 15 proceedings for China Medical Technologies Inc., a company incorporated in the Cayman Islands. A liquidator was appointed by a court in the Caymans following allegations that China Medical committed securities fraud.

The liquidator secured the right to conduct discovery under Bankruptcy Rule 2004 and sought production of documents from U.S. counsel for an independent audit committee that had been appointed by China Medical's board before bankruptcy. The committee's lawyers raised the attorney/client privilege to preclude production of communications between the firm and the committee. The bankruptcy judge sided with the committee and barred production, only to be reversed by Judge Abrams.

Judge Abrams' opinion probes the complexities of choice of law, evidence and privilege. However, most of her holdings can be stated succinctly.

To start the analysis, the parties agreed that federal law is the applicable common law in governing Fed. R. Evid. 510 disputes arising in Rule 2004 proceedings. Because Rule 2004 discovery is nonadversarial in nature, state law does not apply. Similarly, federal common law includes choice-of-law questions. On those issues, Judge Abrams agreed with the bankruptcy judge.

On choice of law, Judge Abrams similarly agreed that the bankruptcy judge properly applied the "touch base" doctrine because the ultimate issue would be governed by the law of privilege. She also agreed when the bankruptcy judge ruled that the "touch base" doctrine makes U.S. law govern the scope of the privilege.

The "touch base" doctrine, used when communications take place abroad or involve foreign attorneys, calls for the court to defer to the law of the country that has the most compelling interest in deciding whether the communications are privileged. Judge Abrams upheld the bankruptcy judge's findings of fact used to invoke U.S. law when applying the "touch base" principle.

Judge Abrams then turned to the application of U.S. law to communications between the audit committee and the panel's lawyers.

In analyzing whether the Cayman liquidator controlled the privilege, Judge Abrams followed the Supreme Court's 1985 decision in *CFTC v. Weintraub*. That case stands for the proposition that a bankruptcy trustee controls and can waive the privilege regarding pre-bankruptcy communications with a company later in bankruptcy.

Judge Abrams framed the ultimate question as whether the audit committee retained its independence after appointment of the liquidator. She said the bankruptcy judge erred by not extending *Weintraub* to the audit committee because the same considerations apply, even though the Supreme Court's case did not involve an independent committee.

Once they are ousted from company management, the "miscreants," Judge Abrams said, cannot prevent a liquidator from learning the truth and recovering assets. She saw no functional difference between a board of directors and an audit committee after "management is deposed in favor of a trustee or liquidator."

Indeed, Judge Abrams said that the interests of an audit committee would be aligned with "the interests of a trustee or liquidator in bankruptcy." The reasoning of *Weintraub*, she said, does not allow the attorney/client privilege "to operate 'as a shield against the trustee's efforts to identify' corporate assets 'wrongfully diverted or appropriated' by a corporation's management."

The opinion is *Krys v. Paul Weiss Rifkind Wharton & Garrison LLP (In re China Medical Technologies Inc.)*, 15-cv-0167 (S.D.N.Y. Sept. 30, 2015).

American Bankruptcy Institute
Bill on Bankruptcy

Bankruptcy failed to insulate the Wyly brothers from an SEC asset freeze.

SEC Can Freeze Assets Without Violating the Automatic Stay, Circuit Holds

Someone accused of securities fraud cannot file bankruptcy to bar the Securities and Exchange Commission from freezing assets in district court, according to the Second Circuit.

Sam Wyly, his deceased brother Charles and their alleged violations of securities laws gave the appeals court occasion on Dec. 18 to draw the contours more clearly delineating the demarcation between the automatic stay and the exception in Section 362(b)(4) allowing governmental enforcement of police and regulatory powers. After a six-week trial in federal district court in Manhattan, a jury decided in May 2014 that the brothers violated securities laws by using offshore trusts to trade secretly in the stock of companies for which they served on their boards.

Without a jury, District Judge Shira Scheindlin in New York concluded in September 2014 that some $300 million was a reasonable approximation of disgorgement of the brothers' ill-gotten gains, measured by the taxes they improperly evaded. The SEC then moved to freeze their assets. While the motion was pending, Sam filed a chapter 11 petition in Dallas in October 2014. Four days later, Caroline Wyly, the widow of Charles, filed a companion chapter 11 petition.

Judge Scheindlin froze Wyly family assets in an opinion in November 2014 in which she concluded that the automatic stay did not apply. While allowing everyone living expenses, she also froze assets of 16 other family members.

On the automatic stay issue, the family appealed and lost in an opinion by Circuit Judge Jose A. Cabranes. Sam did not appeal the decision, nor did Caroline, who had initiated proceedings in Dallas, where the bankruptcy judge ruled that the automatic stay does not preclude an asset freeze.

Judge Cabranes' opinion focused on the Second Circuit's 2000 decision in *SEC v. Brennan*, in which the appeals court found a violation of the automatic stay because the district court had ordered the repatriation of assets following entry of judgment. In that case, the appeals court believed that repatriation was preparatory to collection of a judgment and thus violated the stay.

The Wyly case was different, Judge Cabranes said, because the asset freeze only preserved the status quo and did not "rise to the level of impermissible *enforcement* of a money judgment." On statutory and policy grounds, he found that the "pre-judgment asset freeze at issue here thus

does not implicate the same concerns as did the post-judgment repatriation and deposit order in *Brennan*."

The result turned in significant part on the contours that Judge Scheindlin gave to the asset freeze. In particular, the freeze will dissolve once the assets are under the bankruptcy court's control. At that point, Judge Cabranes said in a footnote, the "bankruptcy court will continue its work without the involvement of the district court."

The decision was not a total victory for the SEC. With respect to seven family members, the appeals court reversed and remanded, directing Judge Scheindlin to decide whether there was evidence that they had received ill-gotten gains.

The opinion dealt only with the automatic stay and not with the amount of the asset freeze or whether the Wylys violated securities laws.

The opinion is *Miller v. SEC*, 14-4261 (2d Cir. Dec. 18, 2015).

Powers of an assignee for creditors are restrictive, not expansive.

Assignee for Creditors Has No Power to File Bankruptcy, 11th Circuit Says

An assignee for the benefit of creditors in Florida does not have authority or power to put a company into bankruptcy, according to the Eleventh Circuit Court of Appeals.

A company filed a so-called ABC to liquidate assets quickly and cheaply. Despite landing a buyer, the assignee could not consummate the sale. Acting on his own and without authority from the company's board, the assignee filed a chapter 7 petition. The bankruptcy trustee subsequently secured bankruptcy court approval for two settlements, bringing in $260,000.

A creditor unsuccessfully opposed the settlements, contending that the company was in bankruptcy improperly due to lack of proper authorization. The arguments were rejected by the bankruptcy judge and on a first appeal in district court.

In the Eleventh Circuit, the creditor won in an opinion on Dec. 17 by Circuit Judge Julie E. Carnes. She said the ABC did not give the assignee "free-wheeling power to pull it out of the very framework from which his powers as assignee arose and plunge it into a different legal system not of its choosing." She said that Florida's ABC statute does not carry within it "the seeds of its own destruction."

Judge Carnes also refused to dismiss the appeal under the doctrine of equitable mootness, which is typically used to dismiss an appeal from a consummated chapter 11 plan.

Without discussing whether equitable mootness is restricted to appeals from plan confirmations, Judge Carnes applied the usual tests to decide that the appeal was not moot, in large part because the $260,000 was still intact. Although one of the settlements had been consummated, the $260,000 had not been distributed to creditors. She said the transactions were "neither particularly complicated nor irreversible."

The opinion is *Ullrich v. Welt (In re NICA Holdings Inc.),* 14-14685 (11th Cir. Dec. 17, 2015).

Confirmation orders are saddled with another layer of complexity.

Some Confirmation Orders Must Comply with Federal Rule 65

The lengthy and contentious reorganization of LightSquared Inc. gave birth to an opinion holding that a confirmation order must comply with the strictures of Rule 65 of the Federal Rules of Civil Procedure if it includes an injunction enforceable by contempt.

The LightSquared chapter 11 case was a battle that pitched the bankrupt satellite communications provider against Dish Network Corp. and its chairman, Charles Ergen. LightSquared contended in an adversary proceeding that Ergen tried to crater the reorganization so that he and Dish could purchase the debtor's satellite frequencies at a bargain price. The lawsuit concluded with an opinion by the bankruptcy judge in which she ruled that Ergen's secured claims should be equitably subordinated.

The reorganization itself culminated with a confirmation order containing an injunction specifically intended to preclude Ergen and Dish from interfering with LightSquared's business after confirmation. Ergen's company appealed, contending that the special injunction was too broadly worded.

District Judge Katherine B. Forrest of Manhattan agreed with Ergen in her opinion on Oct. 7. In substance, the offending injunction would have prevented any creditor or an affiliate from hindering the reorganized company in any manner with respect to implementing its business plan or obtaining frequency licenses from the government. The injunction did allow creditors to contact the government "for any reason."

Because the confirmation order included a restraint enforceable by contempt, Judge Forrest held that it must comply not only with Section 105(a) of the Bankruptcy Code, but also with Fed. R. Civ. P. 65.

Judge Forrest faulted the confirmation order because the injunction contained no endpoint. It also failed to identify the parties enjoined. She held that it could only enjoin Ergen and his companies because they were the only parties for which the bankruptcy judge made findings of fact justifying restraint.

The district judge also set aside the injunction because it was "difficult, if not impossible, for enjoined parties to know precisely what conduct is prohibited." The lack of clarity created a risk, she said, "of chilling ordinary commercial activity."

Rather than attempt to craft an acceptable injunction, Judge Forrest remanded the case to the bankruptcy court.

The opinion contains another holding of note. Ergen argued that the injunction improperly continued the bankruptcy court's jurisdiction after confirmation, but Judge Forrest said that was not fatal.

Although the Second Circuit has not ruled out the continuation of jurisdiction after confirmation, the appeals court has a preference for ending jurisdiction "as soon as practicable," Judge Forrest said. Nonetheless, she held that the time for cutting off jurisdiction is best left to bankruptcy courts in the first instance.

The opinion is *SP Special Opportunities LLC v. LightSquared Inc. (In re LightSquared Inc.)*, 539 B.R. 232 (S.D.N.Y. Oct. 7, 2015).

Specific intent to benefit the lender not required before surcharging collateral.

Fifth Circuit Clarifies Rule on Surcharging Collateral Under Section 506(c)

An unsuccessful reorganization allowed the Fifth Circuit to refine the standard for surcharging a secured lender for the costs of maintaining collateral under Section 506(c).

The opinion, issued on Dec. 29 by Circuit Judge Gregg Costa, included a low-key split with the Seventh Circuit on a sub-issue.

The lender argued that surcharge is permissible only if the trustee or debtor intended to benefit the secured creditor specifically and exclusively. Judge Costa rejected that formulation, holding that surcharge is proper if it primarily benefitted the collateral and was "direct and quantifiable."

The case involved a company whose real property was appraised for $6 million and encumbered for less than $4 million. Everyone evidently believed at the outset of chapter 11 that the property could be sold, leaving a surplus for unsecured creditors. The liquidating chapter 11 plan put the property in trust for subsequent sale.

The trustee landed an offer for less than the secured debt. The lender refused to permit a sale because the trustee conditioned the sale on the recovery of costs to preserve and maintain the property. Eventually, the bankruptcy court authorized the trustee to abandon the property and surcharge the lender. The lender appealed the surcharge directly to the Fifth Circuit.

Judge Costa said that Section 506(c) only requires a showing that the expenses were reasonable, necessary, and of benefit to the creditor. He said courts added a requirement, that the expense "primarily" benefit the secured creditor, to prevent the section "from swallowing the principle that general administrative costs must be borne by the estate."

Judge Costa declined to follow the Seventh Circuit's *Trim-X* decision, which disallows surcharge "when the trustee is trying to realize value for the estate." He also refused to disallow surcharge for expenses incurred before the trustee moves to abandon the collateral.

The lender is protected by a safety valve, because Judge Costa would bar discharge if the "trustee holds an asset longer than necessary to determine and realize its value, and the value turns out to be less than the creditor's secured interest."

The circuit upheld the bankruptcy court, because the findings of direct and primary benefit were not clearly erroneous.

The opinion is *Southwest Securities FSB v. Senger (In re Domistyle Inc.)*, 14-41463 (5th Cir. Dec. 29, 2015).

Fair Debt Collection Practices Act

Circuit split grows on the conflict between the Bankruptcy Code and the FDCPA.

Second Circuit Charts a New Course Favoring Debtors on the FDCPA

The Second Circuit handed down a debtor-friendly opinion on Jan. 4 accentuating an existing split of circuits and laying the foundation for the Supreme Court to decide whether the Bankruptcy Code precludes claims to any extent under the federal Fair Debt Collection Practices Act, or FDCPA.

A woman confirmed a five-year chapter 13 plan with monthly payments on her home mortgage, including payments to cure arrears. After completing her plan payments, she got a discharge in 2013 and soon thereafter defaulted on the mortgage.

The loan servicer dunned her for pre-discharge arrears and post-discharge payments she missed. The woman responded by suing for violations of the FDCPA, contending the lender was attempting to collect personal obligations on the mortgage that had been discharged.

A district judge in Rochester, N.Y., dismissed the suit, holding that the Bankruptcy Code provided the debtor's exclusive remedy for attempting to collect a discharged debt. The district judge believed the proper procedure would have been a motion for contempt of the discharge injunction under Section 105(a).

Circuit Judge Jon O. Newman reversed and reinstated the suit in an opinion largely focusing on the concept of implied repeal.

One federal statute does not supersede another. Instead, when there is an "irreconcilable conflict" between two federal statutes, Judge Newman said the question is whether all or part of the earlier law was repealed "by implication," a concept that is "disfavored."

Judge Newman's opinion was constrained by the circuit's 2010 *Simmons v. Roundup Funding* decision, which barred FDCPA claims during the pendency of a bankruptcy. He interpreted *Simmons* to mean that the FDCPA was inapplicable to claims made during a bankruptcy case. That opinion, he said, did not mean that the FDCPA was impliedly repealed.

Judge Newman was able to reach a different result and reinstated the FDCPA suit by distinguishing the facts in *Simmons*, where the claim arose before discharge. The new case, argued in October, was based on actions taking place after discharge, when the debtor no longer had protection from the bankruptcy court, the circuit opinion said.

There is an extant conflict among the circuits, according to Judge Newman. In 2002, he said, the Ninth Circuit precluded FDCPA claims brought during bankruptcy. In 2004, the Seventh Circuit ruled that the statutes only "overlap" and lack any "irreconcilable conflict," enabling debt collectors to comply with both simultaneously.

The Third Circuit similarly found no implied repeal.

Distinguishing *Simmons*, the Jan. 4 decision holds that the Bankruptcy Code does not "broadly repeal" the FDCPA for claims based on alleged violations of the discharge injunction.

Distinguishing the facts in *Simmons* rests tenuously on the notion that a debtor has no protection from the bankruptcy court after discharge. In reality, the debtor could reopen his or her case to enforce the discharge injunction and seek damages for contempt. In that respect, Judge Newman's opinion and *Simmons* lay the groundwork for rehearing *en banc*, in which all active circuit judges could consider whether the Bankruptcy Code ever precludes claims under the FDCPA, since the Second and Seventh Circuits are not on the same page.

When debt collectors allegedly violate either the automatic stay or the discharge injunction, debtors prefer using the FDCPA because it carries more favorable remedies, including the automatic recovery of the plaintiff's attorneys' fees if the claim is upheld.

The opinion is *Garfield v. Ocwen Loan Servicing LLC*, 15-527 (2d Cir. Jan. 4, 2016).

District judge ignores the circuit's policy argument to allow claims on time-barred debts.

Filing a Stale Claim Is Permitted Despite *Crawford*

A district judge in Jacksonville, Fla., is predicting that the Eleventh Circuit, despite its holding in *Crawford v. LVNV Funding LLC*, will decide that the Bankruptcy Code precludes a bankrupt debtor from maintaining a lawsuit for violation of the federal Fair Debt Collection Practices Act based on the filing of a time-barred claim.

In *Crawford*, the Eleventh Circuit was bent on ending the practice where debt collectors buy claims barred by the statutes of limitations but file proofs when the debtors file for bankruptcy. In the 2014 opinion, the circuit held that filing a claim on a stale debt does violate the FDCPA. Because the issue was not raised in the lower courts, the circuit declined to rule on whether the Bankruptcy Code, adopted one year after the FDCPA, bars bankrupts from suing a claim-holder for filing a time-barred claim.

District Judge Harvey E. Schlesinger faced the question that the Eleventh Circuit ducked in *Crawford*. He recited how the Second and Ninth Circuits hold that the Code precludes suits under the FDCPA, while the Third and Seventh permit them.

Judge Schlesinger recognized that one federal law does not preclude another. Instead, he said there is a presumption "against the implied repeal of one federal statute by another." For a later statute to replace another, he said, there must be "irreconcilable conflict."

On that question, lower courts in the Eleventh Circuit are divided, Judge Schlesinger said. Some hold that the Code precludes an FDCPA claim, while others say that it does not.

Judge Schlesinger came down on the side of preclusion, saying that the Code permits filing a claim while the FDCPA does not. His opinion did not address an argument that the Eleventh Circuit used in *Crawford* to find an FDCPA violation. The appeals court said it wanted to end a practice that was forcing trustees and debtors to waste estate funds by knocking out stale claims. Absent objections, other creditors' recoveries will be diluted by distributions on claims no longer enforceable in state courts.

Courts that find preclusion ordinarily posit that claims are not extinguished by statutes of limitations. Rather, enforcement is barred. Because the claim itself survives, the claim-holder has the right to file a proof of claim in bankruptcy, those courts will say. To avoid violating the FDCPA, the claim-holder must nonetheless include sufficient information in the proof to alert the reader that the claim is time-barred, those courts often say.

The opinion is *Mears v. LVNV Funding LLC*, 14-cv-1207 (M.D. Fla. Nov. 5, 2015); for other Florida opinions raising the same issue and reaching the same result, *see Lewis v. LVNV Funding LLC*, 15-civ-61313 (S.D. Fla. Oct. 6, 2015), and *Neal v. Atlas Acquisitions LLC*, 13-cv-1113 (M.D. Fla. Sept. 25, 2015).

Consumer

***Ninth Circuit permits chapter 20 end run on* Dewsnup.**

Circuits Remain Unanimous in Permitting Chapter 20 Strip Off

The Ninth Circuit joins two other courts of appeals and three bankruptcy appellate panels in holding that a mortgage can be "stripped off" through use of so-called "chapter 20."

A chapter 20 strip off typically arises when someone first goes through chapter 7 and gets a discharge while owning a home where debt on the first mortgage is more than the value of the house. Although a bankrupt's personal liability on a valueless second mortgage is eliminated by discharge, the second lien remains on the home as a result of the U.S. Supreme Court's 1993 *Dewsnup* decision, thus leaving the homeowner vulnerable to foreclosure of the second mortgage after chapter 7.

When the same homeowner files a subsequent chapter 13 petition, some bankruptcy courts and district courts do not permit strip off, or elimination of the second mortgage, usually reasoning that strip off is unavailable because the debtors aren't entitled to a discharge in chapter 13.

In an Oct. 1 opinion, Ninth Circuit Judge Jay S. Bybee sided with the Fourth and Eleventh Circuits by holding that a lien can be stripped off in chapter 20. In a case called *Boukatch*, the Ninth Circuit Bankruptcy Appellate Panel allowed strip off in chapter 20.

In the case before the Ninth Circuit, the consumer debtors first filed under chapter 7. They then filed a chapter 13 petition one day after receiving their chapter 7 discharge, which removed the first mortgage on their home as a personal liability. Because liens ride through chapter 7, the mortgage remained on their home. The chapter 13 petition was designed to prevent or delay foreclosure.

In a holding significant for the typical chapter 20 cases, Judge Bybee held that debtors can avoid liens in subsequent chapter 13 cases even though they are not eligible for discharge.

The bank argued unsuccessfully that the chapter 13 case must end in either conversion to chapter 7 or dismissal because the debtors were barred from another discharge since the chapter 7 discharge occurred within four years. Judge Bybee said the Bankruptcy Code is "devoid" of any requirement that a subsequent chapter 13 case must be converted or dismissed when the debtor cannot have a discharge. He also rejected the bank's argument that stripping off a lien in chapter 20 would circumvent Congress's intent to prohibit successive discharges.

Judge Bybee's decision did create a split of circuits on a subsidiary issue. The bank relied on a 2005 Seventh Circuit decision called *Sidebottom* for the proposition that one debtor cannot have chapter 7 and chapter 13 cases pending simultaneously. He followed the Eleventh Circuit's 1989 *Saylors* opinion, which found no per se rule prohibiting simultaneous bankruptcies.

Judge Bybee upheld the bankruptcy court's finding of no bad faith filing because preventing foreclosure is a legitimate use of chapter 13.

To accomplish a chapter 20, the bankrupts must pay their remaining debts in full in their subsequent chapter 13 case, although they are not required to pay the mortgage debt because it would have been eliminated as a personal liability in their prior chapter 7 case.

The Ninth Circuit case was atypical because the debtors were not stripping off a subordinate mortgage. Instead, a mistake by the bank allowed them to eliminate the first mortgage on their $450,000 home.

In the chapter 13 case, the debtors objected to the bank's secured claim, contending that their signatures had been forged. Perhaps thinking that the lien nonetheless would pass through chapter 13, the bank did not object, and the bankruptcy court entered an order disallowing the secured claim. Using Section 506(d), Judge Bybee said the bank's lien therefore became invalid once the chapter 13 plan was confirmed and the debtors completed payments.

In subsequent cases, lenders might argue that ratification of chapter 20 strip off is *dicta* because the case could have been decided purely on Section 506(d). That argument might not hold weight, however, because the bank argued unsuccessfully in the circuit that the chapter 13 case should have been dismissed.

The opinion is *HSBC Bank USA v. Blendheim* (*In re Blendheim*), 803 F.3d 477 (9th Cir. Oct. 1, 2015).

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Ninth Circuit BAP removes another potential barrier to using "chapter 20."

Stripped-Off Mortgages Don't Count Toward Chapter 13 Unsecured Debt Limits

The Ninth Circuit Bankruptcy Appellate Panel handed down *Free v. Malaier (In re Free)* on Dec. 17, blocking another theory that would have prevented the invocation of so-called chapter 20.

In chapter 20, consumers first file under chapter 7 to extinguish personal liability on an underwater mortgage, then use chapter 13 to strip off the mortgage lien that survives chapter 7 as an *in rem* liability solely against the real property. Chapter 20 accomplishes the aim of stripping off an underwater mortgage, although the Supreme Court's 1992 *Dewsnup* decision holds that a mortgage cannot be stripped off in chapter 7.

The appellate panel's decision came less than three months after the Ninth Circuit handed down *HSBC Bank USA v. Blendheim* (*In re Blendheim*) on Oct. 1, joining two other circuits and three bankruptcy appellate panels in validating the use of chapter 20.

In *Free*, a couple owned a home worth $425,000. It had three mortgages totaling more than $1 million. First filing in chapter 7, the couple reduced the second and third mortgages to wholly unsecured claims. Two days after receiving a chapter 7 discharge of their personal liability on the subordinate mortgages, they filed a chapter 13 petition.

The chapter 13 trustee objected to the couple's eligibility for chapter 13, contending the $535,000 in debt on the second and third mortgages gave them more than the permissible $383,175 in unsecured debt allowed by Section 109(e). The bankruptcy judge bought the argument and dismissed the chapter 13 petition.

Bankruptcy Judge Meredith A. Jury of Riverside, Calif., reversed in her opinion for the appellate panel.

Principally, she distinguished the Supreme Court's 1991 decision in *Johnson v. Home State Bank*. That case, she said, held only that the creditor's right to proceed *in rem* on an underwater mortgage gave rise to a claim that could be addressed in a chapter 13 plan, even though the debt itself had been wiped out in a prior chapter 7 case as an *in personam* liability.

Judge Jury held in substance that *in personam* debts discharged in a prior chapter 7 are not to be counted toward the unsecured debt limit in a subsequent chapter 13. She was careful to say

that the holding did not dispense with any argument that the subsequent filing was in bad faith. However, that contention by itself will no longer be available in the Ninth Circuit in a typical chapter 20 case as a result of *Blendheim*.

The opinion is *Free v. Malaier (In re Free)*, 14-1395 (B.A.P 9th Cir. Dec. 17, 2015).

A split is brewing on chapter 13 debt limits for couples filing jointly.

Georgia Judge Retains Individual Debt Limit for Joint Chapter 13s

A split is growing among the bankruptcy courts on the debt limit for a couple filing jointly in chapter 13.

Arguably referring to joint filers, the last half of Section 109(e) limits eligibility in chapter 13 to "an individual with regular income and such individual's spouse ... that owe, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts that aggregate less than $373,175...."

According to Bankruptcy Judge James R. Sacca of Atlanta, five courts interpret the section to mean that spouses who file jointly have twice the individual unsecured debt limit. He found one judge, from Illinois, who held that the $373,175 limit also applies to a joint filing.

The case before Judge Sacca involved a couple who filed jointly, each with regular income. For each spouse separately, the individual and joint debts were less than the limit. Aggregated, however, their debts exceeded the limit.

Judge Sacca upheld the trustee's objection to confirmation of the plan, saying that Section 109(e) "expressly treats the unsecured debts of joint debtors in the aggregate." Courts holding to the contrary rely on policy arguments, not the language of the statute, according to Judge Sacca.

Judge Sacca rejected the argument that the last half of Section 109(e), quoted above, applies to cases where one spouse has regular income and the other does not.

Used in connection with the debt limit, the word "aggregate" was pivotal for Judge Sacca. It means, he said, that $373,175 is the couple's aggregate debt limit.

Judge Sacca may have an overly narrow reading of the statute because each spouse can have debt up to the limit if they file separately. The text could be interpreted to make a couple eligible for chapter 13 if their aggregate debt is less than the limit when only one spouse has regular income.

Courts should keep in mind that the statute was written when women were less likely to be working mothers.

The opinion is *In re Pete*, 15-63725 (N.D. Ga. Dec. 8, 2015).

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Massachusetts judges disagree on 'forced vesting' in chapter 13 plan.

Lenders Win Again, Beating Back Forced Vesting of Title through Chapter 13

Bankruptcy Judges Melvin S. Hoffman and Henry J. Boroff, both of Massachusetts, disagree on forcing a mortgage-holder to take title to property under a chapter 13 plan.

Last year, Judge Hoffman held that the chapter 13 plan in a case called *Sagendorph* could force a lender to take title. Otherwise, the debtor would be stuck with nondischarged post-petition costs for maintaining and insuring the property until the lender forecloses.

Judge Boroff reached the opposite result in an opinion on Jan. 13 and refused to confirm a plan calling for so-called forced vesting. He listed lower court decisions from around the country reaching different results on the issue.

Previously, Judge Boroff held that Section 1325(a)(5), which lists mandatory plan provisions, bars forced vesting unless a lender consents. He held in the new case that Section 1322(a)(9)'s optional provisions do not change the result, even though he was sympathetic to the plight of communities suffering from a blight of abandoned homes.

The opinion is *In re Weller*, 12-40418 (D. Mass. Jan. 13, 2016).

Employing nonattorneys is a false economy for debt collectors.

11th Circuit Upholds $40,000 in Punitive Damages for Stay Violation

A debt collector was socked with $40,000 in punitive damages and attorneys' fees for trying to save money by using poorly trained nonattorneys.

A consumer filed for bankruptcy a few days after being sued in state court for the collection of a debt. Although the debtor immediately called the collection agency to say he had filed for bankruptcy, the suit continued, with service of process on the debtor personally and entry of a default judgment.

A month after the debtor sued in bankruptcy court alleging a willful violation of the stay, the collection agency finally dismissed the state court suit. However, the debt collector denied all the material allegations in the adversary proceeding.

The bankruptcy judge held a trial and granted $2,000 in compensatory damages for emotional distress, $10,000 in punitive damages and $30,000 in attorneys' fees. The bankruptcy judge said the debtor was entitled to punitive damages to discourage the debt collector "from continuing to use unsophisticated advocates to prosecute collection actions as a cost-savings measure."

The district court set aside the $2,000 in compensatory damages for lack of evidence but sustained the remainder of the judgment.

The Eleventh Circuit upheld the district court in a *per curiam* opinion on Dec. 17, saying that the debt collector "acted with reckless disregard of the automatic stay by using nonattorney staff to prosecute small claims actions for the admitted purpose of lessening its legal costs."

The appeals court held that punitive damages were proper to serve the "dual purpose of punishing" the debt collector and "deter[ing] it from committing future similar misconduct."

The debt collector argued that the debtor was not entitled to attorneys' fees because there were no "actual damages." The circuit panel rebuffed this contention, saying that "actual damages" under Section 362(k) include attorneys' fees because the debtor was compelled to file suit to stop collection actions.

The opinion is *Parker v. Credit Central South Inc. (In re Parker)*, 15-11204 (11th Cir. Dec. 17, 2015).

Simple mistake mushrooms into $50,000 in punitive damages for stay violation.

Using Untrained Personnel Is No Defense Against Willful Stay Violation

Improperly garnishing $666 from a chapter 13 debtor's wages resulted in an award of $50,000 in punitive damages and up to $32,000 in attorneys' fees, even though the garnishee sustained only $1,500 in actual damages.

Chief Bankruptcy Judge William R. Sawyer of Birmingham, Ala., imposed punitive damages to deter the recurrence of the creditor's "deplorable" conduct. The saga began as the result of a simple mistake and was exacerbated because the creditor employed poorly trained nonlawyers to cut the cost of debt collection, Judge Sawyer said.

A lender intended to collect a $666 deficiency on an auto loan from someone named Peggy Vaughan. In the state court summons, the creditor incorrectly spelled the last name as Vaughn.

After the borrower defaulted, the creditor sent a garnishment notice to Vaughan's employer, but again misspelled the name as Vaughn and included neither the actual judgment debtor's social security number nor her home address.

It turned out that the employer had another employee named Peggy Vaughn. The employer began docking Vaughn's paycheck. Vaughn, it turned out, was in bankruptcy.

The garnishee, Vaughn, called the creditor and explained that she was in bankruptcy and owed nothing to the creditor. The creditor, according to Sawyer, did not correct the mistake for five months, after it had collected $666.

Meanwhile, Vaughn had filed an adversary proceeding. After trial, Judge Sawyer handed down his findings and conclusions on Dec. 2, awarding $1,500 in actual damages for a willful stay violation under Section 362(k) because the bankrupt was deprived of the use of $666. He did not give an award for emotional distress because the debtor had not proven damages.

Judge Sawyer found "appropriate circumstances" for punitive damages, given the creditor's "slothfulness" in halting the garnishment and paying back the money. The additional damages were proper, he said, even though the creditor's "egregiousness" lay in its inaction, not in its action.

Judge Sawyer said that the creditor had "an affirmative duty to act with utmost haste" when it was originally notified of the mistake in a phone call from the debtor. He did not cut off an award of attorneys' fees when the stay violation ended because the adversary proceeding had been properly commenced. He is holding further proceedings to decide whether he will award the entire $32,000 in fees the debtor is requesting.

The opinion is *Vaughn v. Central Mississippi Credit Corp. (In re Vaughn)*, 14-8010 (M.D. Ala. Dec. 2, 2015).

Florida judge closes loophole on a debtor's duty to "perform his intention" regarding surrender.

Surrendering Property Precludes a Debtor from Opposing Foreclosure

After a statement of intention to surrender a homestead, the chapter 7 debtor must turn over possession to the mortgage-holder and may not oppose foreclosure, even if the trustee in the meantime has abandoned the property and title reverted to the debtor.

That was the teaching in a Nov. 23 decision by District Judge Kenneth A. Marra in West Palm Beach, Fla., upholding the bankruptcy court.

The debtors admitted that the mortgage debt exceeded the value of their home and stated their intention to surrender the property, which the trustee abandoned. Meanwhile, the bank initiated foreclosure.

The debtors contended that the trustee's abandonment of the property gave them title again and restored their prepetition rights, including the ability to oppose foreclosure. Judge Marra agreed with the bankruptcy judge and disagreed with the debtors.

The question on appeal was whether the debtors fully discharged their obligations when they abandoned the property to the trustee. Judge Marra said they did not.

Although "surrender" is not defined in the Bankruptcy Code, Judge Marra said it means that the debtor abandons any interest in the property as to the trustee and a lienholder. Although the debtor is not required to deliver physical possession to the lender, Judge Marra held that the owner cannot "interfere with the secured creditor's ability to obtain legal title to, and possession of, the property through legal means."

Some might question Judge Marra's next statement that "defending against a foreclosure proceeding relating to the secured property would be inconsistent with the debtor's stated intention to surrender the property."

Judge Marra concluded the opinion by holding that a trustee's abandonment of a property only restores title to the bankrupt and "does not affect other aspects of the debtor's rights and responsibilities relative to the property."

The decision might also be questioned for its lack of exploration of the last clause in Section 521(a)(2)(B), which provides that a decision to surrender "shall [not] alter the debtor's or the trustee's rights with regard to such property."

The opinion is *Failla v. CitiBank NA*, 15-civ-80328 (S.D. Fla. Nov. 23, 2015).

Practice Point: File in Missouri before receiving an exempt public assistance benefit.

Public Assistance Received Before Filing Loses Its Exemption

A woman in Missouri had the misfortune of filing for bankruptcy five hours after receiving a $5,000 earned income tax credit. The trustee objected to the debtor's claimed exemption and won all the way from the bankruptcy court through the Eighth Circuit.

In May, by a decision in *Hardy v. Fink*, the Eighth Circuit gave a generous reading to "public assistance benefit." In that case, the appeals court reversed the lower courts by holding that a federal Additional Child Tax Credit received after filing qualifies under Missouri law as an exempt public assistance benefit.

In a case decided on Nov. 17, the outcome in the Eighth Circuit was different because the tax refund arrived before filing, resulting in the denial of the exemption.

Circuit Judge Myron H. Bright relied on a Missouri appellate opinion interpreting the state statute as terminating the exemption with regard to "funds already received."

The opinion is *Dittmaier v. Sosne* (*In re Dittmaier*), 15-1340 (8th Cir. Nov. 17, 2015).

Someone expecting increasing income should file in the Seventh Circuit.

Seventh Circuit Is Safe Harbor for Chapter 13 Debtors with Increasing Income

Seventh Circuit precedent, as interpreted by a district judge in Springfield, Ill., allows a chapter 13 debtor to avoid an involuntary plan modification if the debtor's income rises.

A couple filed under chapter 13 in May 2010 and confirmed a plan in March 2011 requiring payments of $660 a month. When the trustee saw their 2012 income tax return, he filed a motion in June 2013 seeking an increase in monthly payments because their annual income had risen $50,000 compared with 2011.

The bankruptcy judge denied the motion and was upheld on Sept. 30 by District Judge Sue E. Myerscough.

The case turned on the Seventh Circuit's *Witkowski* decision from 1994, which holds that plan modifications are permissible only if they fit within one of the provisions enumerated in Section 1329(b).

Since the calculation of disposable income in Section 1325(b) is not listed in Section 1329(b), increased income is no grounds for granting a trustee's motion to increase plan payments, Judge Myerscough held. Although she acknowledged that courts outside of the Seventh Circuit have required plan modifications if a debtor's income rises, those courts, she said, are not controlled by *Witkowski*.

Having held that the bankruptcy judge did not err as a matter of law, there was no occasion for Judge Myerscough to decide whether there had been an abuse of discretion.

The opinion is *Germeraad v. Powers (In re Powers)*, 14-03128 (C.D. Ill. Sept. 30, 2015).

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Ninth Circuit adopts Second Circuit standard limiting derivative standing.

Trust Beneficiary Lacks Standing in a Dispute Between Debtor and Trust

The sole beneficiary of a trust lacks standing as a "party in interest" under Section 1109(b) to participate in a bankruptcy court dispute between the trust and the debtor, the Ninth Circuit held.

A man was the sole beneficiary of a trust created by his father. The trust sold property to the debtor and provided seller financing. The buyer confirmed a plan that modified the debt. A dispute later arose, resulting in a settlement between the trustees and the debtor.

In bankruptcy court, the beneficiary objected unsuccessfully to the settlement. The bankruptcy court found that the beneficiary was a party in interest, although it was a close question, the judge said.

The beneficiary appealed the approval of the settlement, but the district judge dismissed the appeal, saying the beneficiary lacked standing. The Ninth Circuit upheld dismissal on Sept. 28 in an opinion by Circuit Judge Jay S. Bybee.

For standing, a litigant must satisfy three criteria, Judge Bybee said. First, the litigant must be a party in interest under Section 1109(b). Second, the litigant must satisfy the constitutional minimum required by Article III. Third, the litigant must satisfy the federal court's prudential standards. "Party in interest" is not defined in the Bankruptcy Code.

Because the beneficiary did not qualify under Section 1109(b), Judge Bybee did not address the other issues.

Although the Ninth Circuit has said that "party in interest" must be "construed broadly," the appeals court previously ruled that suffering "collateral damage" does not give rise to a "legally protected interest" that confers standing.

Judge Bybee adopted the Second Circuit's 2007 *Refco* opinion, which denies standing to someone whose rights "are purely derivative of another party's."

Although the beneficiary might suffer damage, the injury was derivative and therefore did not confer standing.

The opinion is *Hughes v. Tower Park Properties LLC* (*In re Tower Park Properties LLC*), 803 F.3d 450 (9th Cir. Sept. 28, 2015).

Arbitration

Creditors bat 500 this fall when trying to compel arbitration in the Southern District of New York.

Subordination Clause Held Ineligible for Arbitration

With different results, arbitration clauses were the topic of two decisions handed down within two weeks of each other in Manhattan district courts.

The liquidation of Lehman Brothers Inc. teaches that an arbitration clause cannot be enforced when the issue concerns the subordination of hundreds of employees' claims.

In a case decided a fortnight later, individual debtors trying to mount class actions were unable to overcome an arbitration clause. That case, *Belton v. GE Capital Consumer Lending Inc.*, is discussed in the following item.

The case where creditors lost involved Lehman, the largest broker ever liquidated. Decades before it went bankrupt, the brokerage established a deferred compensation plan allowing senior employees to set aside some of their income in exchange for retirement benefits to be paid years or decades later. To comply with tax laws, the plan provided that the workers' claims would be subordinated to all other creditors' claims in the event of bankruptcy.

The compensation plan called for arbitration of disputes in the stock exchange. Hundreds of employees joined together and filed a motion calling on the bankruptcy judge to have an arbitrator decide whether the subordination clause was enforceable.

The bankruptcy judge made findings of fact at the conclusion of a hearing and denied the arbitration motion. Manhattan District Judge Edgardo Ramos upheld the bankruptcy judge in an opinion on Sept. 30. The employees are appealing to the Second Circuit; their brief currently is not due until Feb. 10.

Judge Ramos began with the proposition that the policy in the Federal Arbitration Act favoring arbitration must be "rigorously enforced," to use words penned by the Supreme Court. According to Second Circuit precedent, arbitration clauses will be overridden only when there is an "inherent conflict" between arbitration and another statute.

In the bankruptcy context, the Second Circuit has a two-part test, the first being an analysis of whether the dispute is core or non-core. Even if the question is core, the second part of the test provides that an arbitration clause will not be overridden unless litigation outside of bankruptcy

court "would seriously jeopardize the objectives of the Bankruptcy Code," the Second Circuit proclaimed in *MBNA Bank NA v. Hill*.

Judge Ramos held that the bankruptcy court correctly decided that subordination issues are "quintessentially core bankruptcy proceedings." He also upheld the bankruptcy court's findings of a "severe conflict" between arbitration and the Code's objectives.

Given the lower court's findings, there was no abuse of discretion in refusing to compel arbitration, Judge Ramos held.

The opinion is *344 Individuals v. Giddens (In re Lehman Brothers Holdings Inc.)*, 14-civ-7643 (S.D.N.Y. Sept. 30, 2015).

Bankrupts are left to the mercy of arbitrators to enforce discharge injunctions.

Creditors Can Compel Arbitration of Discharge Violations

A former bankrupt must arbitrate a claim that a creditor violated the discharge injunction by reporting that a debt was charged off rather than erased in bankruptcy, according to a district judge in White Plains, N.Y.

It is unclear from the decision whether the result would have been different had the debtor been seeking to enforce the discharge injunction only in his or her own case and not as a class action.

Two debtors reopened their chapter 7 cases to file class action suits against creditors that had told credit-reporting agencies that their debts were charged off, not discharged. The debtors contended that the erroneous reports violated their discharge injunctions under Section 524(a)(2).

When Bankruptcy Judge Robert Drain denied the creditors' motions to enforce arbitration clauses in their credit agreements, the creditors appealed and won a reversal from District Judge Vincent L. Briccetti on Oct. 14.

Judge Briccetti relied in significant part on the Second Circuit's 2006 decision in *MBNA America Bank v. Hill*, which upheld an arbitration clause when the debtors filed class actions to enforce the automatic stay.

The result turned on the Federal Arbitration Act and its "liberal federal policy favoring arbitration," Judge Briccetti said. The question for him was whether Congress intended to preclude arbitration of a statutory federal right, as shown by an "inherent conflict" between arbitration and the Bankruptcy Code.

Judge Briccetti was persuaded by Section 1334(b) of the Judiciary Code, which does not give bankruptcy courts exclusive jurisdiction over claims arising under the Bankruptcy Code. In the creditors' favor, he cited the provision in Section 1334 giving bankruptcy courts exclusive jurisdiction over awards of compensation, thus cutting against the notion that Congress did not intended to exempt discharge enforcement from arbitration.

There was no "severe conflict" between the Bankruptcy Code and the Federal Arbitration Act that would "seriously" and "necessarily" jeopardize the "goal of centralized resolution of purely bankruptcy issues," Judge Briccetti said. Citing *MBNA America Bank*, he held that it is

not enough to allege "a violation of an important, even fundamental, Bankruptcy Code provision."

The debtors are moving for leave to take an interlocutory appeal to the Second Circuit.

Judge Bricetti did not cite the *Lehman* case, decided two weeks earlier, in which another Southern District judge found a "severe conflict" and upheld a decision by the bankruptcy court barring arbitration over the subordination of claims. The *Lehman* decision, by District Judge Edgardo Ramos, is discussed above.

The opinion is *Belton v. GE Capital Consumer Lending Inc. (In re Belton)*, 15-cv-1934 (S.D.N.Y. Oct. 14, 2015).

Opinions on arbitration are all over the map.

Arbitration Barred to Facilitate Trustee's Suit

An opinion by District Judge Robert E. Blackburn of Denver implies that an arbitration clause will not be enforced if it would hinder or bar a trustee from prosecuting a lawsuit.

Within two years of bankruptcy, the debtor paid about $9,000 to a "debt resolution service." The chapter 7 trustee sued in bankruptcy court to recover the payments as constructively fraudulent transfers under Section 548. The second claim in the complaint sought recovery of the same payments for allegedly exceeding fees allowed under Colorado state law.

Among the three defendants, one had an agreement with the debtor calling for arbitration. Although the policy under the Federal Arbitration Act requires vigorous enforcement of arbitration agreements, the bankruptcy judge allowed the suit to proceed.

Judge Blackburn reached the same conclusion in his opinion on Dec. 10.

The Section 548 claim is not one the bankrupt could have brought, Judge Blackburn said. Thus, the trustee's claim was not derivative of the debtor's rights. Consequently, the trustee was not required to arbitrate because the trustee was not a party to the arbitration agreement and did not step into the debtor's shoes.

The trustee's state law claim was derivate of the debtor's rights, thus requiring arbitration unless splitting up the suit "would substantially undermine the orderly, efficient and effective administration of the bankrupt estate," Judge Blackburn said.

The bankruptcy judge concluded that arbitrating the state law claims would be contrary to the "Bankruptcy Code's fundamental policies of centralized resolution of purely bankruptcy issues." Because Judge Blackburn held that the bankruptcy judge's findings of fact were "amply supported in the record," he upheld denial of arbitration of the state law claims.

The opinion is *Larson v. Swift Rock Financial Inc. (In re Craig),* 15-0674 (D. Colo. Dec. 10, 2015).

Cross Border – Chapter 15

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Judge Gerber pens a treatise on consequences of bad-faith chapter 15 filing.

Minimal Activities in Foreign Liquidation Are No Basis for Chapter 15 Recognition

Bankruptcy Judge Robert E. Gerber authored an important opinion on cross-border insolvency when he held that a foreign liquidator's "minimal" activities before a chapter 15 filing do not provide a basis for finding that the center of main interest, or COMI, moved from the place of business to the liquidator's jurisdiction.

Judge Gerber, sitting in Manhattan, said that the debtor's "tactics were a paradigmatic example of bad faith." Although he did not dismiss the chapter 15 petition for bad faith, his 74-page opinion contains extensive *dicta* describing how a court in the future could respond to a bad-faith filing if the requirements of foreign recognition were otherwise met.

The case presented facts that are amusing to the reader, albeit maddening to the creditor opposing recognition of the foreign liquidation.

The debtor corporation did most of its business in the U.K., where the English High Court of Justice was on the cusp of entering a $5.6 million judgment in favor of the creditor, which later opposed so-called foreign main recognition in the U.S. Before the judgment was entered, the company initiated a voluntary liquidation in the British Virgin Islands, where it could appoint its own liquidator. The debtor also moved $9.5 million out of the U.K. to prevent attachment in that country.

The company only provided the liquidator with enough financing to perform the "statutory bare minimum," Judge Gerber said. The liquidator then filed the chapter 15 petition.

Judge Gerber said in his Jan. 13 opinion that the company intended to invoke chapter 15 and obtain an injunction preventing the creditor from seizing assets in the U.S., a strategy the judge called "egregious bad faith."

The opinion is an application of the Second Circuit's 2013 *Fairfield Sentry* decision to a different set of facts. In that case, the appeals court held that a COMI could move to the jurisdiction where the foreign liquidation is located, thus justifying recognition of a foreign main proceeding.

His case was different, Judge Gerber said, because the debtor failed to satisfy Section 1517(a) since the British Virgin Islands liquidation did not qualify as a foreign main proceeding given the paucity of activities in that venue.

Judge Gerber held that a so-called letterbox jurisdiction can be the COMI "only where material activities have been undertaken in the jurisdiction in which the foreign proceeding was filed." To support his conclusion, he interpreted *Fairfield Sentry* as meaning that "a COMI manipulated in bad faith would not be a valid COMI."

Based on the same fact findings, Judge Gerber said the British Virgin Islands did not qualify as a venue for the foreign non-main proceeding because there was no "establishment" there.

Judge Gerber did not say directly whether bad faith can be grounds for dismissal of a chapter 15 petition. Instead, he devoted a good portion of his opinion to analyzing how a court could respond short of dismissing if the chapter 15 debtor were in demonstrable bad faith.

Even if the court were constrained to grant foreign main recognition, Section 362 has a safety value for bad faith, Judge Gerber said in *dicta*. That section, applicable in chapter 15 by Section 1520(a)(1), allows a court to modify the automatic stay. He went on to say that modifying the automatic stay for "cause" has "long been a classic remedy for bad faith filing."

Judge Gerber buttressed his analysis by reading *Fairfield Sentry* to mean that a "bad faith invocation of the Code" can "trump any apparent COMI" based on "literal compliance with the requirements of Section 1517."

The opinion is *In re Creative Finance Ltd. (In Liquidation)*, 14-10358 (Bankr. S.D.N.Y. Jan. 13, 2016).