

# **The 12 Top 10 Bankruptcy Cases of the Year**

Federal Bar Association Annual Meeting, September 2012

Presented by the Bankruptcy Law Section

Panelists:

The Honorable Peter W. Bowie (moderator)

United States Bankruptcy Judge, Southern District of California

The Honorable Harlin DeWayne “Cooter” Hale

United States Bankruptcy Judge, Northern District of Texas

The Honorable Alan S. Trust

United States Bankruptcy Judge, Eastern District of New York

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**The Limited Catch-All Properties of the Chapter 11 Cramdown: The Supreme Court’s Interpretation of § 1129(b)(2)(A) and its “Indubitable Equivalent” Provision**

*RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. \_\_\_, 132 S. Ct. 2065 (2012).

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The October 2011 Term presented the Supreme Court with the task of interpreting the Chapter 11 Cramdown to determine if a secured lender may bid with credit against its debt or must bid with cash at auction to prevent another party from taking possession of its collateral. In *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, a unanimous Court held that a debtor cannot confirm its plan under the “indubitable equivalent” catch-all of § 1129(b)(2)(A)(iii) if its plan sells a secured lender’s collateral free and clear of its lien, but does not permit the lender its credit-bid.<sup>1</sup>

The *RadLAX* Court made an “easy case” of a strongly contested conflict between debtors and creditors involved in Chapter 11 reorganizations.<sup>2</sup> It agreed with Congress’ intention to give effect to every clause and part of each statute when a general and specific clause exist side-by-side to avoid a general provision from engulfing its specific counterpart.<sup>3</sup> The decision is lender-friendly and arguably prevents a debtor from confirming a Chapter 11 plan under the Cramdown if a portion of its plan conflicts with a clause specifically covered within the statute.<sup>4</sup>

**Factual Background**

RadLAX Gateway Hotel, LLC and RadLAX Gateway Deck, LLC (“Debtors”) purchased a hotel at Los Angeles International Airport and the empty lot adjacent to it in

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<sup>1</sup> 132 S. Ct. 2065, 2073 (2012).

<sup>2</sup> *Id.*

<sup>3</sup> See *id.* at 2071 (quoting *D. Ginsberg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932)).

<sup>4</sup> *Id.* at 2065.

2007.<sup>5</sup> Ultra Construction Loan Investment Fund, for which Amalgamated Bank (“Lender”) served as trustee, loaned \$142 million to the Debtors to finance the purchase and renovation of the hotel and the construction of a parking structure on the lot, securing a purchase-money security interest in the collateral.<sup>6</sup>

The Debtors had spent all funds and were forced to cease construction after only two years of work.<sup>7</sup> Because the Debtors still owed significant amounts to the Lender and they could not obtain adequate funding elsewhere, they voluntarily filed a Chapter 11 bankruptcy petition.<sup>8</sup> At the time of the filing, the Debtors owed more than \$120 million and the debt was accumulating over \$1 million in interest each month.<sup>9</sup>

### **Procedural History**

The Debtors submitted their Chapter 11 plan to the United States Bankruptcy Court for the Northern District of Illinois for confirmation under § 1129(b)(2) (“Cramdown”).<sup>10</sup> The plan sought to sell substantially all of the Debtors’ assets at auction to the highest bidder, with the proceeds to be distributed among the secured creditors.<sup>11</sup> The Debtors’ filed an additional “Sale and Bid Procedures Motion” with the bankruptcy court proposing that their encumbered assets be sold free and clear of their liens, but did not permit its secured creditors to bid with credit from their outstanding debt.<sup>12</sup> The Debtors’ plan instead forced their secured creditors to bid on the collateral with cash.<sup>13</sup> Because the Debtors’ plan impaired the Lender’s interests and the Lender did not accept

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<sup>5</sup> *Id.* at 2068.

<sup>6</sup> *RadLAX*, 132 S. Ct. at 2068.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 2069.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *RadLAX*, 132 S. Ct. at 2069.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

the plan under § 1129(a)(8), the Debtors' plan could only be confirmed by the bankruptcy court under the Cramdown.<sup>14</sup>

The Lender objected to the plan and argued that it violated § 1129(b)(2)(A)(ii)'s requirement that secured creditors retain the right to credit-bid unless otherwise made impermissible by the court.<sup>15</sup> The Debtors claimed that the court could still confirm their plan under § 1129(b)(2)(A)(iii)'s "indubitable equivalent" standard, which, unlike clause (ii), did not expressly foreclose asset sales without credit-bidding.<sup>16</sup> The bankruptcy court ultimately denied the Debtors' bid procedure motions, and the Debtors subsequently filed notices of appeal requesting the bankruptcy court to certify appeal directly to the Seventh Circuit.<sup>17</sup>

The Court of Appeals for the Seventh Circuit accepted the certification and affirmed the bankruptcy court's determination.<sup>18</sup> Reviewing the bankruptcy court's decision *de novo*, the court held that the Cramdown does not permit a debtor to sell encumbered assets free and clear of a lien without permitting the lienholder to credit-bid.<sup>19</sup> It reasoned that if a debtor was able to have its plan confirmed under the general requirement of clause (iii) while nonetheless violating either clause (i) or (ii) of the Cramdown, it would render the first two clauses superfluous.<sup>20</sup> The Debtors appealed the Seventh Circuit's decision to the Supreme Court.<sup>21</sup>

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<sup>14</sup> *Id.*

<sup>15</sup> *See id.* *See also* 11 U.S.C. § 1129(b)(2)(A)(ii) (2006) (the credit-bid right exists in the cross-reference to § 363(k)).

<sup>16</sup> *RadLAX*, 132 S. Ct. at 2069.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *RadLAX*, 132 S. Ct. at 2069.

## Issue Before the Court

The Supreme Court granted *certiorari* on the one issue:

1. Whether a debtor can obtain confirmation of its Chapter 11 plan under § 1129(b)(2)(A)(iii) when the plan provides for the sale of collateral free and clear of its liens, but does not permit a secured lender to bid for such collateral using its debt to offset the purchase price.

## Court's Analysis

The Court focused its short opinion on the statutory interpretation of the Chapter 11 Cramdown. In the opinion authored by Justice Scalia, the Court did not agree with the Debtors' reading of § 1129(b)(2)(A).<sup>22</sup> The Court used the general/specific canon of statutory construction to reject both the Debtors' interpretation of the Chapter 11 Cramdown and the Debtors' arguments against the canon's application.<sup>23</sup> Its opinion corroborated the lower courts' view that debtors "seeking to sell their property free and clear of liens under § 1129(b)(2)(A) must satisfy the requirements of clause (ii), not the requirements of *both* clauses (ii) and (iii)."<sup>24</sup>

The Court first explained that the general/specific canon prevents clause (iii), the general clause, from rendering clause (ii) useless. The canon requires that where a specific and general clause exist side-by-side in the same statute, the specific clause must be followed and the general clause must be utilized only in instances that fall outside the specific's scope.<sup>25</sup> The Court found the Debtors' attempted confirmation under clause (iii) conflicted with the canon's reading of the Cramdown because clause (ii), through cross-

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<sup>22</sup> *Id.* at 2070.

<sup>23</sup> *Id.* at 2071.

<sup>24</sup> *Id.* at 2072

<sup>25</sup> *Id.* at 2071 (quoting *United States v. Chase*, 135 U.S. 255, 260 (1980)).



reference to § 363(k), required secured lenders to have the option to credit-bid in the event of a sale of secured collateral free and clear of its liens.<sup>26</sup>

Next, the Court dismissed the possibility that clause (ii) was a safe harbor. The Court concluded that the Cramdown's structure did not intend for such an interpretation and that the "indubitable equivalent" clause is a residual rule because Congress placed the Cramdown's specific provisions in clauses (i) and (ii) and placed the general, "indubitable equivalent" provision in clause (iii).<sup>27</sup>

The Court also rejected the Debtors' objections to the canon's application. The Debtors claimed that (1) the statute's language provided three distinct options to fulfill the cramdown over a secured creditor's objection, (2) clause (ii) is no more specific than clause (iii), and (3) the Seventh Circuit confused the approval of the plan's bid procedures with the plan's confirmation.<sup>28</sup> The Court rejected the Debtors' claims by (1) reminding the Debtors that the issue was which one of the clauses they must satisfy, not whether they must comply with more than one,<sup>29</sup> (2) reasoning that the canon concerns only the scope of the rules, so the procedural or substantive nature of the clauses is irrelevant,<sup>30</sup> and (3) explaining that any distinction is irrelevant as a matter of law because the Debtors' bid procedures would not satisfy § 1129(b)(2)(A), respectively.<sup>31</sup>

The Court commented that the general/specific canon made this particular situation an "easy case."<sup>32</sup> Noting the Bankruptcy Code's general statutory purpose of protecting secured creditors, leaving debate of credit-bidding for Congress, and finding no other

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<sup>26</sup> *RadLAX*, 132 S. Ct. at 2071.

<sup>27</sup> *Id.* at 2072.

<sup>28</sup> *See id.*

<sup>29</sup> *Id.* at 2072.

<sup>30</sup> *Id.* at 2072-73.

<sup>31</sup> *RadLAX*, 132 S. Ct. at 2073.

<sup>32</sup> *Id.*

ambiguity in the Cramdown, the Court determined that the Debtors' did not satisfy clause (ii) and thus, the bankruptcy court could not confirm their plan.<sup>33</sup>

## Holding

The Court, affirming the Seventh Circuit in an 8-0 opinion, held that

1. A debtor may not obtain confirmation of a Chapter 11 plan under the Cramdown that provides for the sale of collateral free and clear of a lender's lien, but does not permit a lender to credit-bid.<sup>34</sup>

## Forecast

Overruling a recent Fifth Circuit judgment<sup>35</sup> and affirming the minority approach in the Third Circuit,<sup>36</sup> the Court's decision in *RadLAX* brings a new view to this area of law and it will have significant national impact on the future interpretation of the Chapter 11 Cramdown.

After *RadLAX*, lenders are further protected from losing their rights in collateral in which they have a secured interest. The Court found that the "indubitable equivalent" clause provides discretion to the bankruptcy courts to determine what is "fair and equitable" for reorganization only when the Bankruptcy Code does not enumerate a standard.<sup>37</sup> Although statutory reasoning dominated the Court's decision, a footnote within the opinion revealed that the Court may have been influenced by the potential impact from the Debtors' reading of the Cramdown.<sup>38</sup>

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<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 2073.

<sup>35</sup> See generally *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

<sup>36</sup> See *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010) (Ambro, C.J., dissenting).

<sup>37</sup> 11 U.S.C. § 1129(b)(2).

<sup>38</sup> *RadLAX*, 132 S. Ct. at 2070, n.2 (noting that the Federal Government may have an interest in preventing a debtor from carving out credit-bidding because it is often-situated as a secured creditor in bankruptcies and does not have the ability to "throw good money after bad" in a cash-only sale of collateral).

A decision favoring secured lenders is not inconsistent with the Bankruptcy Code, but if the Court continues to support its Code-based opinions solely with textual construction and avoid debtor concerns, the number of future Chapter 11 reorganizations may diminish because debtors will realize that their chances getting their plan approved outside of creditor consent are futile.

**A New Crop for Spring: Individual Farmer-Debtors Face New Dilemmas  
for Taxes on Capital Gains**

*Hall v. United States*, 132 S. Ct. 1882 (2012).

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Summer 2012

This past spring, seeds were being planted and not just in farming fields across the country. The seeds of a 5-4 Supreme Court decision were also placed into the legal fields of bankruptcy and tax law which will now prohibit Chapter 12 debtors from treating post-petition, capital gains tax liabilities as estate claims. Prior to the May 14, 2012 decision, farmer debtors were able to find some relief from paying full capital gains on post-petition sales in Chapter 12 cases. Pursuant to § 1222(a)(2)(A) of the Bankruptcy Code, farmer debtors may treat certain claims owed to the government as general unsecured claims that can be discharged after less than full payment. These claims must first hold priority status as indicated in § 507 of the Bankruptcy Code to qualify for the exception in § 1222. Priority status claims include administrative expenses allowed under § 503(b) including any tax “incurred by the estate.” Thus, if a claim has been incurred by the estate and holds a priority status, it may be eligible for the § 1222 carve out exception which would strip the claim of priority status, thereafter be treated as an unsecured claim, and become dischargeable prior to full payment.

However, in a recent decision, the Supreme Court held the meaning of “incurred by the estate” to not include capital gains tax liability for a sale of property during the pendency of a Chapter 12 Bankruptcy. This prevents claims of priority status from being treated as a general unsecured claim and thus becoming dischargeable.

## **Factual Background**

Lynwood and Brenda Hall petitioned for a Chapter 12 bankruptcy and shortly thereafter sold their farm, leaving them with a capital gains tax liability of \$29,000. Petitioners sought the exception provision of Chapter 12, § 1222, claiming the tax from the sale had been “incurred by the estate” and could therefore be stripped of priority status and treated as an unsecured claim.<sup>39</sup> The IRS challenged petitioners’ reorganization plan, claiming that taxes arising from a post-petition farm sale are the debtors’ independent responsibility rather than the bankruptcy estate’s obligation.

## **Procedural History**

The bankruptcy court rejected petitioner’s request to claim their tax as an unsecured claim, finding that a Chapter 12 estate is not a separate taxable entity under the Internal Revenue Code (“IRC”)<sup>40</sup> and therefore cannot “incur” taxes.<sup>41</sup> This decision was reversed by the district court, holding that Congress intended § 1222 to extend to post-petition taxes. The district court did not believe that IRC provisions were relevant to interpreting § 503(b). On appeal, the Ninth Circuit reversed, acknowledging the relevance of the IRC’s taxable entity provisions to the Bankruptcy Code and held that post-petition taxes do not qualify for the exception.

## **Issue Before the Court**

1. Is capital gains tax liability resulting from a sale of property during the pendency of a Chapter 12 bankruptcy considered to be “incurred by the estate” and thus dischargeable as a general, unsecured claim?

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<sup>39</sup> See 11 U.S.C. § 1222(a)(2)(A) (2006).

<sup>40</sup> See 26 U.S.C. §§ 1398, 1399 (2006).

<sup>41</sup> See 11 U.S.C. § 503(b).

## Majority's Analysis

With split authorities<sup>42</sup> the case was brought before the Supreme Court of the United States who determined the meaning of § 503(b) “incurred by the estate” to bear a plain language meaning. This would give liability to the estate for expenses brought upon the estate through its *own* actions, not those of the debtor. Here, the trustee of the estate did not sell the property; rather, the debtors sold the property and brought the capital gains tax from the sale upon themselves. Additionally, the IRC provides that only certain estates are liable for federal income taxes.<sup>43</sup> The bankruptcy estate is liable for the taxes when an individual debtor files for a Chapter 7 or 11, as such estates are separate taxable entities. However, in Chapter 12 and 13 cases, there is no separately taxable entity. Thus, the federal income tax liability that results from post-petition farm sales are not “incurred by the estate” and neither collectible nor dischargeable for family farmers with regular annual income.

The Court bolstered the decision through examining the statute's context. Reading § 346 of the Bankruptcy Code *in pari materia* with the IRC's §§ 1398-1399, the provisions provide that except for individual Chapter 7 or 11 cases, no separate taxable entities result from the commencement of bankruptcy cases. The Supreme Court's examination of legislative history showed that there has been a “longstanding interplay” between the IRC and Bankruptcy Codes where Bankruptcy Code § 346 was amended to follow the chapter-specific taxable entity rules of the IRC when assigning federal tax liabilities. Further,

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<sup>42</sup> Judge Paez of the Ninth Circuit dissented, citing to *In re Dawes*, 652 F. 3d 1236 (10th Cir. 2011) and *Knudsen v. IRS*, 581 F. 3d 696 (8th Cir. 2009) that found post-petition federal taxes *are* eligible for the §1222(a)(2)(A) exception and thus dischargeable.

<sup>43</sup> See 26 U.S.C. §§ 1398, 1399.

because the debtor files the tax return and is generally liable for taxes, the debtor (not the estate) is responsible for the post-petition taxes incurred from the sale of their property.<sup>44</sup>

Finally, the Supreme Court highlighted the statutory structure to confirm that post-petition income taxes are not “incurred by the state.” Chapter 12 provisions were modeled after Chapter 13 in the Bankruptcy Code. Thus, Chapter 13 cases can be relied upon as authority in Chapter 12 cases.<sup>45</sup> Chapter 13 post-petition taxes have never been held as administrative expenses, have been considered to be incurred by the debtor, and clearly fall outside of the provisions of § 503(b). The Court found no reason to depart from these findings for Chapter 12 cases. Both chapters reference other sections of the IRC and Bankruptcy Code in an identical manner that could lead to disruptive understandings inconsistent with current practices.

The Court also rejected petitioners’ temporal meaning argument and merger argument. Petitioners reasoned that estates only come into existence after a bankruptcy petition is filed. Therefore, “incurred by the estate” language of § 503(b) refers to all post-petition taxes regardless of the chapter in which the claim is filed. However, this reasoning would make every liability that arises after filing automatically the responsibility of the estate. Petitioners also sought to establish that taxes that are paid out of an estate’s assets should be considered “incurred by the estate,” but this defies the ordinary meaning of “incur” by placing liability on the estate when the estate did not bring the liability upon itself. The Supreme Court emphasized Congress’ efforts to distinguish tax liabilities when borne by the debtor versus those borne by the estate. Finally, the Court differentiated between administrative expenses that involve corporate-debtors as well as Chapter 7 or 11

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<sup>44</sup> See H.R. Rep. No 95-595, p.277 (1977).

<sup>45</sup> See 8 COLLIER ON BANKRUPTCY ¶1200.01[5] at 1200-1210 (Alan N. Resnick and Henry J. Sommer eds. 2011); *In re Lopez*, 372 B.R. 40, 45, n. 13 (B.A.P. 9th Cir. 2007); *Justice v. Nalley Nat. Bank*, 849 F. 2d 1078, 1083 (8th Cir. 1988).

administrative expenses from those similar to the present issue in Chapter 12 individual-debtor petitions. Although strong policy reasons may exist for treating post-petition income tax liabilities as dischargeable, to do so would upset the statute's plain language, context, and structure, as well as create a rippling effect of conflicting decisions with broader bankruptcy schemes that presently exist.

## **Dissent**

A forceful and practical dissent focused on whether the amendment of § 1222(a) applies to this post-petition tax liability. Assuming the majority's interpretation, the dissent argued that when post-petition taxes do not fall within the meaning of § 507, then the amendment to § 1222 does not apply to these taxes, and this liability would technically fall outside the scope of the bankruptcy proceeding altogether. But Congress did not intend for this result. The amendment was placed to aid farmer-debtors who needed to sell/dispose of their property to help make their payments in compliance with their Chapter 12 plan. Therefore the amendment was made in such a way to place the government farther back in the line of creditors collecting so that priority creditors and secured claim holders would be paid first and the government could then seek payment from the remaining funds. The dissent noted that if the government could collect these post-petition taxes without regard to priority creditors and secured claim holders, then the farmer-debtor would effectively not be able to proceed under Chapter 12 at all because he would be left with insufficient assets to satisfy the statutory criteria. The majority's interpretation of the relevant language effectively denies the amendment of its intended effect.

The dissenting Justices looked to the legislative history for the basic objective that Congress was trying to achieve at the time the exception provision was added.<sup>46</sup> The

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<sup>46</sup> See 145 Cong. Rec. 1113 (1999) ("Under current law, farmers often face a crushing tax liability if they need to sell livestock or land in order to reorganize their business affairs...Why should the



purpose of the § 1222(a) exception was to allow farmer-debtors to seek relief from crushing debt through Chapter 12 plans. However, allowing the government to collect these taxes would lead to the very results the amendment sought to prevent: inability for individual farmer-debtors to use Chapter 12 to reorganize their debts. Additionally, the majority's reading of § 503(b) was unnecessarily narrow and does not provide for a reading with a broader interpretation of "estate." Understanding that the "estate" refers to the bankruptcy estate would permit the post-petition taxes to fall within the provisions of the statutory language because when a farmer, during the pendency of Chapter 12 proceedings, sells a portion of his farm, the bankruptcy estate has "incurred" the associated tax. This argument is supported by similarly broad language use in other areas of the Bankruptcy Code revisions.<sup>47</sup>

Another diverging opinion the dissent held was the differential effects on individual farmer-debtors in post-petition tax liability. The majority's holding allows for the corporate farmer-debtor to utilize the exception provision in managing their post-petition taxes as an administrative expense; however, the decision provides no such relief for the individual farmer-debtor. The majority's interpretation is problematic because it allows for other inconsistencies such as other kinds of post-petition taxes (e.g., employer taxes, social security taxes, and Medicare taxes) being considered "administrative" even though incurred by the individual debtor and not the estate. The dissent reasoned that if both Chapter 12 and 13 (not just Chapter 13) cases were able to treat their post-petition taxes as "administrative" during the interim of petition filing and plan approval, then the purpose of the exception provision would not be frustrated and congressional intent would be honored.

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I.R.S. be allowed to veto a farmer's reorganization plan? [The amendment] takes this power away from the I.R.S. by reducing the priority of taxes during proceedings. [This will] help farmers stay in the business of farming."]; *see also* 14A J. Mertens, LAW OF FEDERAL INCOME TAXATION §54:61, p.11 (Oct. 2011 Supp.).

<sup>47</sup> See H.R. Rep. No. 95-595, p.193 (1977); S. Rep. No. 95-1106, p. 13 (1978).

## Forecast

The majority's specific-language interpretation win over the dissent's purpose-driven interpretation could lead to several changes within the upcoming years in bankruptcy law. Perhaps the most significant change will be fewer Chapter 12 individual-debtor filings. When the individual farmer files for Chapter 12 assistance and subsequently sells his property, he may not roll his capital gain tax claim into his reorganization plan. However, to proceed with a Chapter 12 plan after payment to priority/secured claims, the farmer must still have enough assets to guarantee unsecured creditors the minimum amounts that Chapter 12 plans require. Depending on the size of this tax liability, if the farmer does not have the minimum amounts (like \$29,000 in the *Hall* case) he may not be eligible to use Chapter 12. This preclusion will either prohibit farmers seeking Chapter 12 altogether or it may generate more denials for the number of Chapter 12 petitions sought.

Another effect this decision may have is an increase in filings within other chapters or fewer filings altogether. Individual farmer-debtors may seek to reorganize their affairs through Chapter 11 reorganizations. However, one effect is certain: the individual farmer-debtor will now have more debt going forward.

The fruits of the Supreme Court's *Hall* decision have yet to be reaped. Whether the decision produces a good or bad crop lies in the future.

## **Is Individual Chapter 11 a Catch-22?**

*In re Maharaj*, 681 F.3d 558 (4th Cir. 2012) and  
*In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012).

Bryan J. Hall, Esq., Law Clerk to the Honorable Alan S. Trust

Because of the strict debt limits for Chapter 13<sup>48</sup>, many individuals who own homes in high-priced areas or who operate small businesses must file a Chapter 11 petition to reorganize. However, individual Chapter 11 is far from a supersized Chapter 13; Chapter 11 adds numerous additional requirements to confirm a plan, including preparing a disclosure statement and soliciting votes on a plan. A key question for individual Chapter 11 debtors left unresolved by the 2005 amendments to the Bankruptcy Code in the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”) is whether an individual Chapter 11 debtor can retain property of the estate if all creditors are not to be paid in full. The issue has caused a split among courts, as reflected in *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012) and *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012).

### **Factual Backgrounds**

#### **Maharaj**

Debtors Ganess and Vena Maharaj owned and operated an auto body repair shop and filed an individual Chapter 11 petition after being the victims of an apparent fraud. *Maharaj* 681 F.3d at 566. Debtors proposed a plan under which Debtors would retain all property of the estate including their ownership interest in the business entities through which the auto body repair shop was operated. *Id.* at 567; *In re Maharaj*, 449 B.R. 484, 488-89 (Bankr. E.D. Va. 2011). Debtors solicited votes for their plan, but the only unsecured creditor to vote on the plan, Discovery Bank, voted against the plan on the

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<sup>48</sup> See 11 U.S.C. § 109(e) (debtor must have noncontingent, liquidated unsecured debts of less than \$360,475 and noncontingent, liquidated secured debts of less than \$1,084,400; both debt limits are subject to adjustment every three years under § 104).

ground that it violated the absolute priority rule. *Maharaj*, 681 F.3d at 567. Although expressing sympathy for the debtors, the bankruptcy court held that BAPCPA had not abrogated the so-called absolute priority rule, which requires that all creditors be paid in full before junior interests – such as the debtors’ equity interest in the estate’s assets – can receive anything on account of their previous interest. *Id.* Therefore, the court denied confirmation. *Id.* The bankruptcy court certified its ruling for direct appeal to the Fourth Circuit Court of Appeals pursuant to 28 U.S.C. § 158(d)(2)(A)(i). *Id.*

### Friedman

Gregory and Judith Friedman, who lived in Arizona, operated a high speed internet service provider in Colorado, where they owned a second home. *Friedman*, 466 B.R. at 473. The second home served as collateral for certain business loans. *Id.* at 474. The business filed Chapter 11, but that case was eventually dismissed. *Id.* P+P, LLC, a secured creditor that held a junior mortgage lien on the Colorado home, obtained a judgment of foreclosure, which precipitated the debtors filing an individual Chapter 11 petition in Arizona. *Id.* Because of the decline in real estate values, P+P, LLC’s claim was rendered unsecured, and debtors classified it with other unsecured claims. *Id.* at 475-76. P+P dominated the unsecured class and voted against the plan on the basis of absolute priority. *Id.* at 476. The bankruptcy court held that the absolute priority rule still applies in individual Chapter 11s, denied confirmation of the debtors’ plan, and converted the debtors’ case to Chapter 7. *Id.* at 476-77. The Debtors’ appealed to the United States Bankruptcy Appellate Panel of the Ninth Circuit. *Id.* at 472.

## Issue Before the Courts

1. Whether the 2005 BAPCPA amendments to § 1129(b)(2)(B)(ii) and § 1115 modified the absolute priority rule as to individual Chapter 11 debtors to exclude only postpetition acquired property and earnings as defined in § 1115(a) or whether the amendments also exclude from absolute priority all property of the estate as defined in both §§ 541 and 1115.

## Discussion

The absolute priority rule is designed “to prevent deals between senior creditors and equity holders that would impose unfair terms on unsecured creditors.” *Friedman*, 466 B.R. 471, 478 (citing *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482, 508 (1913)).<sup>49</sup> The rule is codified in § 1129(b)(2)(B)(ii) as part of the Bankruptcy Code’s requirement that a Chapter 11 plan be “fair and equitable.” *Maharaj*, 681 F.3d at 562. To meet this requirement, when a class of unsecured creditors votes against a proposed plan, the plan is only “fair and equitable” if it provides that “the holder of any claim or interest that is junior to the claims of such [dissenting] class will not receive or retain under the plan on account of such junior claim or interest any property.” *Id.* (quoting § 1129(b)(2)(B)(ii)). As a result, “if the proposed plan allow[s] the debtor to retain property, any dissenting creditors must be paid in full” for the plan to be approved. *Id.*, citing *Norwest bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988).

Prior to BAPCPA, courts were in near unanimous agreement that absolute priority applied in individual Chapter 11s. *Friedman*, 466 B.R. 471, 479 n.16. However, through BAPCPA, Congress amended § 1129(b)(2)(B)(ii) and added § 1115 to provide an exception

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<sup>49</sup> The absolute priority rule is tempered by the “new value exception” which permits equity to retain control of the debtor and estate assets if old equity contributes “money or money’s worth.” *Friedman*, 466 B.R. at 478, citing *Case v. Los Angeles Lumber Prods., Co.*, 308 U.S. 106, 122 (1939).

to the absolute priority rule for individual Chapter 11 debtors so that “the debtor may retain property included in the estate under section 1115.”<sup>50</sup> 11 U.S.C. § 1129(b)(2)(B)(ii).

As *Maharaj* and *Friedman* reflect, two competing views have arisen as to what Congress meant by exactly what property is “included in the estate under section 1115.” The “narrow view” adopted in *Maharaj* holds that the individual debtor exception to the absolute priority rule applies only to the postpetition acquired property and earnings that are added to property of the estate for an individual Chapter 11 debtor by virtue of § 1115 and not property of the estate that is defined by § 541. The “broad view” adopted in *Friedman* holds that the individual debtor exception to the absolute priority rule in § 1129(b)(2)(B)(ii) applies to all “property of the estate” as defined in § 541 as well as to postpetition acquired property and earnings that are included in the estate by § 1115.

The broad view effectively abrogates the absolute priority rule in individual Chapter 11 cases, which the narrow view narrowly construes the BAPCPA amendments to merely

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<sup>50</sup> Section 1129(b)(2)(B)(ii), as amended, requires that a Chapter 11 plan provide the following treatment for any class of unsecured claims:

the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, *except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section.*

11 U.S.C. § 1129(b)(2)(B)(ii) (2005 amendment emphasized). Section 1115 provides that:

(a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541—

(1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted . . . ; and

(2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted . . . .

(b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

11 U.S.C. § 1115.

allow an individual Chapter 11 debtor “to retain property and earnings acquired after the commencement of the case that would otherwise be excluded under § 541(a)(6) & (7).”

*Maharaj*, 681 F.3d at 563; *Friedman*, 466 B.R. at 482.

### ***Maharaj* – the Narrow View**

More than a dozen bankruptcy courts, including five in the Ninth Circuit, adopted the narrow view that BAPCPA did not abrogate the absolute priority rule for individual Chapter 11 debtors.<sup>51</sup> A few of these courts adopted the narrow view based on the plain language of §§ 1129(b)(2)(B)(ii) and 1115, which they held “preserved the absolute priority rule in unambiguous terms.” *Maharaj*, 681, F.3d at 565. The Fourth Circuit in *Maharaj* was not convinced, finding the language of § 1129(b)(2)(B)(ii) and § 1115 to be “susceptible to more than one reasonable interpretation.”<sup>52</sup> *Id.* at 568.

Accordingly, the Fourth Circuit looked to canons of statutory interpretations and the specific context in which the ambiguous language is used and the broader context of the statute as a whole. *Id.* at 569. In looking at context, the Fourth Circuit agreed with the

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<sup>51</sup> *Maharaj*, 681, F.3d at 565, citing, *inter alia*, *In re Arnold*, 471 B.R. 578, (Bankr. C.D. Cal. May 17, 2012); *In re Tucker*, 2011 WL 5926757 (Bankr. D. Or. 2011); *In re Borton*, 2011 WL 5439285 (Bankr. D. Idaho 2011); *In re Kamell*, 451 B.R. 505 (Bankr. C.D. Cal. 2011); *In re Karlovich*, 456 B.R. 677 (Bankr. S.D. Cal. 2010); *In re Gbadebo*, 431 B.R. 222 (Bankr. N.D. Cal. 2010). Despite these prior rulings, it appears that the Ninth Circuit B.A.P.’s ruling in *Friedman*, 466, B.R. 471, is controlling. See *In re Windmill Farms, Inc.*, 70 B.R. 618, 622 (B.A.P. 9th Cir. 1987), *rev’d on other grounds*, 841 F.2d 1467 (9th Cir.1988) (“to provide a uniform and consistent body of bankruptcy law throughout the entire Circuit . . . the decisions of the Bankruptcy Appellate Panel must be binding on all of the bankruptcy courts from which review may be sought, i.e. each district in the Ninth Circuit.”). However, B.A.P. decisions are not binding on Article III courts in the Ninth Circuit. *Bank of Maui v. Estate Analysis, Inc.*, 904 F.2d 470, 472 (9th Cir. 1990).

<sup>52</sup> The key provisions in dispute are: “property included in the estate under section 1115” found in § 1129(b)(2)(B)(ii) and “property of the estate includes, in addition to the property specified in section 541” found in § 1115.” *Maharaj*, 681 F.3d. at 569. According to the Fourth Circuit, “property included in the estate” in § 1129(b)(2)(B)(ii) could be interpreted under the narrow view as property “added to” the estate by § 1115 (i.e., only postpetition acquired property and earnings), or under the broad view as property that is “referenced” in § 1115 (including both § 541 and the postpetition acquired property and earnings added by § 1115); “either construction is plausible.” *Id.* Similarly, the Fourth Circuit found that § 1115’s language, “in addition to property specified in section 541,” could be interpreted under the narrow view as “not essential” introductory text and not part of the property added to the estate by § 1115, or under the broad view § 541 could be interpreted as a “subset” of property in § 1115. *Id.*

bankruptcy court in *In re Karlovich*, 456 B.R. 677, 681, that the purpose of § 1115 was to include property acquired postpetition and postpetition earnings in property of the estate for individual Chapter 11 debtors and afford it protections such as the automatic stay, and § 1129(b)(2)(B)(ii)’s complementary purpose was to then exclude post-petition acquired property and earnings from the absolute priority rule. *Id.* at 569-70. As to broader context, the Fourth Circuit found that its reading of § 1115 paralleled a recent Sixth Circuit Court of Appeals’ decision interpreting the Chapter 13 corollary, § 1306, as simply augmenting § 541 to include post-petition acquired property and earnings in property of the estate. *Id.* at 570, citing *In re Seafort*, 669 F.3d 662, 667 (6th Cir. 2012).<sup>53</sup>

In further support of its interpretation, the Fourth Circuit applied the canon against implied revocation, which is especially strong in the bankruptcy context, and found that “Congress made no clear statement of repeal” and that if Congress had intended to abrogate such a “well-established rule of bankruptcy jurisprudence” as the absolute priority rule, “it could have done so in a far less convoluted manner”, such as simply amending that § 1129(b)(2)(B)(ii) applies “except with respect to individuals”. *Id.* at 571; 573. The Fourth Circuit also found “nothing in the BAPCPA’s legislative history that suggests that Congress intended to repeal the absolute priority rule” although it conceded that “BAPCPA’s legislative history is sparse.” *Id.* at 572.

The Fourth Circuit also rejected the debtors’ public policy arguments that application of the absolute priority rule in individual Chapter 11s would make confirmation virtually impossible, concluding that the BAPCPA amendments were not “designed to enhance the individual debtor’s fresh start,” but were instead intended to provide greater protections for creditors. *Id.* at 574-75. Thus, the Fourth Circuit concluded that the

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<sup>53</sup> The Fourth Circuit did not, however, address the fact that the absolute priority rule does not apply in Chapter 13. 11 U.S.C. § 1322(b)(2).



“absolute priority rules as it applies to individual debtors in Chapter 11 has not been abrogated.” *Id.* at 575. Therefore, the court affirmed the bankruptcy court’s decision to deny confirmation of the debtors’ plan. *Id.*

### ***Friedman* – The Broad View**

In *Friedman*, the majority of the B.A.P. rejected this narrow view, holding that the plain meaning of § 1115 creates a broader definition of property of the estate, encompassing those assets included in § 541, as well as the additions to property of the estate in §1115 (a)(1) and (2) for postpetition acquired property and earnings (which are excluded from property of the estate by § 541(a)(6) and (7)). 466 B.R. at 480-81. Under the *Friedman* court’s reading of the statute, the exception to the absolute priority rule applies not only to postpetition acquired property and earnings, but also to the various property of the estate encompassed in § 541, much of which is prepetition property. *Id.* at 482.

As support for its unambiguous interpretation of the statute, the B.A.P. majority cited the fact that there is no provision in Chapter 11 that is inconsistent with its reading of §§ 1129(b)(2)(B)(ii) and 1115. *Id.* at 481-82. The B.A.P. majority also interpreted the BAPCPA amendments as harmonizing the provisions of Chapter 11 related to individual debtors with Chapter 13, noting that numerous provisions that were added to Chapter 11 for individual debtors were borrowed (often nearly verbatim) from Chapter 13. *Id.* at 482-83. The B.A.P. majority also disputed the dissent’s contention that a broad reading of § 1115 rendered § 103(a) superfluous. Section 103(a) makes § 541 applicable in Chapter 11s; the B.A.P. majority first noted that § 103(a) was not amended by BAPCPA as § 1129 and 1115 were; the B.A.P. majority also pointed out that the Chapter 13 corollary to § 1115, § 1306, has never been viewed as superfluous. *Id.* at 482.

One judge on the B.A.P. dissented, taking issue with the majority's view that the statute is unambiguous, finding it susceptible to more than one reasonable interpretation. *Id.* at 487-88. Like the Fourth Circuit in *Maharaj*, the *Friedman* dissent found that the BAPCPA amendments were not intended to more align individual Chapter 11s with Chapter 13; rather, as the dissent pointed out, Congress's stated purpose in enacting BAPCPA was to increase repayment to creditors, not to increase the amount that debtors are able to keep. *Id.* at 490-91.

### **Forecast**

Undoubtedly, this split of authority as to whether the absolute priority rule bars individual Chapter 11 debtors from retaining property of the estate defined in § 541 when an impaired creditor votes against the plan is unlikely to be resolved in the near future. As a result, debtors' counsel needs to be aware of the potential significant impact on individual Chapter 11 debtors if the court applies the absolute priority rule in § 1129(b)(2)(B)(ii). It may also be necessary to negotiate with creditors in advance to avoid objections to an individual Chapter 11 debtor's plan based on the absolute priority rule.

## ***Stern's Interference: New York Bankruptcy Court Denied Authority Over State Law Fraudulent Transfer Claim***

*Kirschner v. Agolia*. 2012 WL 1622496 (S.D.N.Y. May 09, 2012).

Matthew O. Greenberg, J.D. Candidate at Baylor Law School, February 2014,  
Judicial Extern to the Honorable Harlin D. Hale, Summer 2012

### **Procedural History**

Defendants, “Movants,” moved to withdraw the reference to the Bankruptcy Court of the proceedings brought by Plaintiff Trustee of Refco Litigation Trust. The Court withdrew the reference for the issue of determining the following questions.

### **Issues Before the Court**

1. Whether after the United States Supreme Court’s opinion in *Stern v. Marshall*, 131 S. Ct. 2594 (2011) – which held that only an Article III court can finally resolve a state law tortious interference claim that was asserted in a bankruptcy proceeding – the Bankruptcy Court can finally resolve the Trustee’s claims; and
2. If the Bankruptcy Court cannot finally resolve those claims, whether the Bankruptcy Court can still be utilized to recommend findings of fact and conclusions of law for the District Court to consider.

### **Court’s Analysis**

The *Stern* Court held that the underlying tortious interference claim, though core, could not be finally adjudicated by a Bankruptcy Court.<sup>54</sup> Following the *Stern* rationale, this court holds that the underlying fraudulent conveyance claim cannot be finally adjudicated by a bankruptcy court.<sup>55</sup> The private versus public right dichotomy present in *Stern* is analogous to the instant case.

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<sup>54</sup> *Stern v. Marshall*, 131 S. Ct. 2594, 2608 (2011).

<sup>55</sup> *Kirschner v. Agolia*, 2012 WL 1622496, at \*6 (S.D.N.Y. May 09, 2012).

The court investigates the *Stern* Court’s reliance on *Granfinanciera* as an analogy to the present case. The *Stern* Court followed the court in *Granfinanciera*, which held that the Seventh Amendment right to a jury trial applied to fraudulent conveyance actions.<sup>56</sup> The court adopts the *Stern* Court’s finding that fraudulent conveyance actions were suits at common law, and therefore private, not public, rights.<sup>57</sup>

The court notes that the Bankruptcy Court overseeing *Refco* bankruptcy reached a different conclusion. However, the court dismisses that decision as based on cautionary dicta and past practice. This, the court asserts, does not overcome the logic in *Stern*.

Additionally, the Trustee tries to argue that the Bankruptcy Court can grant a Motion to Dismiss (“MTD”) in this case, since MTD’s are pre-trial issues. However, this court reasons that, absent appeal, granting a MTD in effect finally adjudicates the issue, attaching res judicata and collateral estoppel concerns.<sup>58</sup> Therefore, the court holds that questions of the Bankruptcy Court’s jurisdiction are present even at the MTD stage.

Section 157(c)(1) provides clear statutory authority to issue proposed findings of fact and conclusions of law on non-core claims. But there is no express authority that authorizes a bankruptcy court to issue such findings in a case where the bankruptcy court lacks constitutional authority to issue final judgment. For these kinds of core claims, the Code only provides that the bankruptcy court “may enter appropriate orders and judgments.” 28 U.S.C. § 157(b)(1).

However, this court follows the precedent set out by many other courts by holding that a bankruptcy court does have the power to issue a report and a recommendation on a claim over which it does not have the constitutional authority to issue a final judgment.

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<sup>56</sup> *Id.* at \*4

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at \*6.

## **Holdings**

1. No, the Bankruptcy Court cannot finally resolve a state law fraudulent transfer or a state law unjust enrichment case.
2. Yes, the Bankruptcy Court may still issue recommendations of findings of fact and conclusions of law for cases for which it does not have Constitutional authority to issue final judgments.

## **Forecast**

This case continues the ripple-effect from *Stern*, this time extending the *Stern* rationale directly to underlying state law fraudulent conveyance cases. Looking forward, future case law will carve out the types of cases over which bankruptcy courts can exercise jurisdiction and enter final orders.

## **Preferring Public Rights: Houston Bankruptcy Court Uses Public Rights Doctrine to Exercise Authority Over Preference Claims**

*In re Apex Long Term Acute Care-Katy, L.P.*, 465 B.R. 452 (2011).

Matthew O. Greenberg, J.D. Candidate at Baylor Law School, February 2014,  
Judicial Extern to the Honorable Harlin D. Hale, Summer 2012

*Stern* raised significant concerns over bankruptcy courts' jurisdiction, holding that not all claims within the bankruptcy claim fall within the court's jurisdiction. The *Stern* Court held that the claim at issue did not fall within the public rights doctrine. This court seeks to differentiate preference claims as within the public rights doctrine, so as to exercise authority to adjudicate them.

### **Factual Background**

Distribution Trustee for Apex sued for preferential transfers. The Court initially approved, but now the Trustee seeks dismissal with prejudice. In the fourth claim, Trustee seeks default judgment.

### **Issue Before the Court**

1. Do Bankruptcy Courts have the constitutional authority to adjudicate preference claims?

### **Court's Analysis**

*Stern* raised significant concerns over bankruptcy courts' jurisdiction, holding that not all claims within the bankruptcy claim fall within the court's jurisdiction.

The *Stern* Court held that the claim at issue did not fall within the public rights doctrine. This court seeks to differentiate preference claims as within the public rights doctrine, so as to exercise authority to adjudicate them.

The court begins by discussing the *Lagenkamp*, *Granfinanciera*, *Katz* line of cases. Dicta in *Lagenkamp* and *Granfinanciera* indicate preference actions are not public rights,

but *Katz* heads in a different direction. This court will base its decision on the overruling precedent of the *Katz* decision.

Discussing the origins and reach of the public rights doctrine through a discussion of *Thomas v. Union Carbide*, this court reviews *Stern* and decides that the only avenue through which bankruptcy courts can have jurisdiction over preference claims is through the public rights theory. It says that no other doctrine outside the public rights doctrine exists that would allow a bankruptcy court to adjudicate disputes that closely resemble private rights.

This means that the court is forced to find its answer within the confines of the public rights doctrine. The court holds that: certain fundamental bankruptcy issues fall within the public rights doctrine. This is not directly supported by any Supreme Court decision. It is only alluded to through Supreme Court dicta in *Northern Pipeline v. Marathon*, where the court said that the restructuring of the debtor/creditor relationship may be a public right.

The Supreme Court then began to walk back this very statement in *Stern* and in *Granfinanciera*. But this court holds that *Katz* overrules.

This court analogizes the connection in *Thomas* between public rights doctrine and Article I powers to the connection between the public rights doctrine and the bankruptcy clause. The court discusses the historical aspects of bankruptcy law, including debtors revolts and Shay's Rebellion, as a way to support its claim that bankruptcy is inherently a public matter.

Because *Stern* held that not all bankruptcy matters are within the bankruptcy court's jurisdiction, the court must decide whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process.

The court also notes that the pre-1978 distinction of summary versus plenary powers is not completely analogous to the core versus non-core distinction.

This case turns on the court's interpretation of *Katz*. *Katz* describes the states as having consented to *in rem* jurisdiction of bankruptcy courts. The *in rem* considerations mirror those of the summary versus plenary distinction. The court holds that preference actions stem from and are primarily pursuant to *in rem* jurisdiction, and thus are within the jurisdiction of the bankruptcy court.

In effect, this court argues that the *in rem* of the bankruptcy estate can extend to 90 days before petition under § 547. If the *res* includes property 90 days from petition, then the court has jurisdiction over it. If the *res* includes § 547 property, then the court can enforce § 550(a) also.

### **Holdings**

1. Prior to ruling on Trustee's motions, court first had to determine whether it had constitutional authority to adjudicate preference claims, and
2. Bankruptcy court had constitutional authority, pursuant to public rights doctrine, to adjudicate adversary proceedings brought to avoid preferential transfers.

### **Forecast**

Judge Isgur makes creative use of the public rights doctrine, to avoid the action falling the way of *Stern*. If future courts can characterize motions as public rights, then they can avoid the *Stern* pitfall. Judge Isgur here clothes preference claims in the shroud of the public rights doctrine. Future courts may try the same approach, but with varying results.



## **Fraud, Credit, and Judgments: The Eleventh Circuit Rules Payoff as a Fraudulent Transfer**

*In re TOUSA*, 680 F.3d 1298 (11th Cir. 2012).

Travis J. Cox, J.D. Candidate at Baylor Law School, July 2013,  
Judicial Extern to the Honorable Harlin D. Hale, Summer 2012

Unsecured creditors brought an adversary proceeding against prepetition lenders that provided payment to venture lending to avoid transfer of liens to new lenders and recover the value from the venture lenders under 11 U.S.C. § 548(a)(1)(B). After an extensive trial, the bankruptcy court disgorged the profits of the transaction because the lack of reasonably equivalent value. The district court quashed the order. In *Senior Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re TOUSA)*, 680 F.3d 1298 (11th Cir. 2012), the Eleventh Circuit reinstated the bankruptcy court's decision.

### **Factual Background**

TOUSA was the thirteenth largest homebuilding enterprise in 2006. However, it acquired its size by constantly buying independent homebuilders, turning them into subsidiaries. TOUSA financed these acquisitions primarily by taking on additional debt. The subsidiaries ended up controlling most of the assets of TOUSA and generated nearly all its revenue.

In 2005, TOUSA entered a joint venture to acquire Transeastern Lenders assets by borrowing money from Transeastern. However, by 2006 there was a default on the Transeastern loan. Transeastern alleged two billion dollars in damages. By 2007, the TOUSA settled with Transeastern for \$421 million. To finance the settlement, TOUSA and some of its subsidiaries incurred new debt. This transaction was contested by several parties within TOUSA, stating that it was necessary for equity to incur some of these costs because taking debt to pay a settlement when the housing market was crashing would force the whole enterprise into bankruptcy. The transaction was paid in a multi-step process,

Citicorp transferring funds to a TOUSA subsidiary, which sent the funds to Transeastern's administrative agent. The agent paid the funds to Transeastern and third parties to cover costs.

Six months after this settlement agreement, TOUSA and its subsidiaries filed a chapter 11 bankruptcy proceeding.

### **Procedural History**

The committee of unsecured creditors ("creditors") alleged the transfer was a fraudulent transfer because the subsidiaries were insolvent when the transfer, were made insolvent by the transfer, had unreasonably small capital, or were unable to pay their debts as they came due. 11 U.S.C. § 548(a)(1)(B). Transeastern countered arguing the subsidiaries received reasonably equivalent value in exchange for granting the liens.<sup>59</sup> The bankruptcy court credited expert opinions that the subsidiaries were insolvent before and after the settlement payments, in assessing if the subsidiaries received 'reasonably equivalent value' in the transaction.<sup>60</sup> In its primary holding, the bankruptcy court found the subsidiaries did not receive value unless they obtained some kind of enforceable entitlement to some tangible or intangible article of property.<sup>61</sup> Because the subsidiaries did not receive property, they could not receive reasonably equivalent value.

Alternatively, the bankruptcy court issued findings under a broader analysis of value.<sup>62</sup> The court addressed Transeastern's claims that the subsidiaries received value by opportunity to avoid bankruptcy, control of the Transeastern property, tax benefits, access to TOUSA corporate services, and access to credit.<sup>63</sup> The bankruptcy court found none of

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<sup>59</sup> *Transeastern Lenders v. Official Comm. of Unsecured Creditors (In re TOUSA)*, 680 F.3d 1298, 1303 (11th Cir. 2012).

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* at 1304.

<sup>62</sup> *Id.*

<sup>63</sup> *In re TOUSA*, 680 F.3d at 1303.

these, or any combination of these values to rise to reasonably equivalent value.<sup>64</sup>

Primarily, the bankruptcy court focused on expert testimony stating an earlier bankruptcy would not harm the subsidiaries.<sup>65</sup> The subsidiaries held most of the assets of the TOUSA enterprise, and could get financing on their own.<sup>66</sup> The bankruptcy court harped on the options TOUSA faced at the time it made the settlement payment, because choosing to pay the settlement with new debt made a bankruptcy for the whole enterprise inevitable.<sup>67</sup> Based on the record it built in a multi-day trial with over a thousand exhibits, the bankruptcy court voided the transfer under § 548, ordered disgorgement of the profits and restored Transeastern's claims against TOUSA.<sup>68</sup>

The district court quashed the bankruptcy court order as to the liability of Transeastern Lenders.<sup>69</sup> The district court held the bankruptcy court too narrowly defined value, citing Third Circuit precedent that “[t]he mere ‘opportunity’ to receive an economic benefit in the future constitutes ‘value’ under the Code.”<sup>70</sup> The district court found the ability to avoid bankruptcy was reasonably equivalent value.<sup>71</sup> The district court also held Transeastern was not a party “for whose benefit” but a subsequent transferee under 11 U.S.C. § 550(a)(1).<sup>72</sup>

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<sup>64</sup> *Id.* at 1304.

<sup>65</sup> *Id.* at 1303.

<sup>66</sup> *Id.* at 1305.

<sup>67</sup> *Id.* at 1308.

<sup>68</sup> *In re TOUSA*, 680 F.3d at 1308.

<sup>69</sup> *Id.* at 1309.

<sup>70</sup> *Id.* (citing *Mellon Bank, N.A. v. Official Committee of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.)*, 92 F.3d 139, 148 (3d Cir.1996)).

<sup>71</sup> *Id.* at 1309.

<sup>72</sup> *Id.* at 1301.

## Court's Analysis

The Eleventh Circuit found there was no clear error to the definition of value, without adopting the version of value the bankruptcy court used.<sup>73</sup> Because the bankruptcy court issued an alternative reasoning based on a broader definition of value, it was unnecessary to adopt the bankruptcy court's ruling.<sup>74</sup> Value is a fact inquiry, thus, the bankruptcy court is given broad latitude to look at the full transaction to define fair consideration and transfer of value.<sup>75</sup> On the issue of value, the Eleventh Circuit cited multiple precedents that stated that any act that extends the life of a corporation is not reasonable value.<sup>76</sup>

## Forecast

The Eleventh Circuit's ruling avoided the contentious redefinition of reasonably equivalent value. However, by passing on the issue the court has left the possibility open in the Eleventh and other circuits of a tightened idea of 'value' for the purposes of avoidance measures.

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<sup>73</sup> *In re TOUSA*, 680 F.3d at 1301.

<sup>74</sup> *Id.* at 1304.

<sup>75</sup> *Id.*

<sup>76</sup> *See id.* at 1314.

## Mother, May I? Barriers to Chapter 9 Municipal Reorganization

Bryan J. Hall, Esq., Law Clerk to the Honorable Alan S. Trust

Bankruptcy is not for everyone. Not every entity can file for bankruptcy protection (e.g., domestic insurance companies and banks cannot file), and the Bankruptcy Code restricts under which chapters other entities may file (e.g., railroads may only file Chapter 11, and only individuals below certain debt limits may file Chapter 13). *See* 11 U.S.C. § 109(b)(1-2), (d), (e) (2011). But the Bankruptcy Code reserves its most onerous requirements to be a “debtor” for municipalities, such as counties, cities, towns, and utility districts. *See* §§ 101(40); 109(c).

Like other provisions of the Bankruptcy Code, the municipal reorganization provisions in Chapter 9 are designed to protect a financially distressed debtor from its creditors while enabling the debtor to renegotiate a repayment of its debts. *See* § 901, *et seq.* Like other debtors, a municipality filing Chapter 9 obtains the protections of the automatic stay and incurs certain responsibilities, such as filing a list of creditors. §§ 362; 901(a); 922(a). A Chapter 9 debtor may also propose and seek confirmation of a plan of reorganization. §§ 941; 943.

Chapter 9 is unlike the other chapters of the Bankruptcy Code in several material ways. For example, Chapter 9 only permits reorganization of a municipal debtor; there is no liquidation provision.<sup>77</sup> Unlike in Chapters 7, 11, 12, 13 and 15, the filing of a voluntary petition under Chapter 9 does not constitute an order for relief. § 921(d). Once the petition is filed, the debtor must publish notice of the filing in a newspaper of general circulation. § 932. Creditors then have an opportunity to object to the putative debtor’s eligibility to file

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<sup>77</sup> *See generally* Francisco Vazquez & Eric Daucher, *Building Blocks: Restructuring a Municipality under Chapter 9*, 29-6 AM. BANKR. INST. J. 50 (July-Aug. 2010); United States Courts website at <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx>.

Chapter 9 before an order for relief may be entered. § 921(c). In Chapter 9, the bankruptcy court's oversight of the debtor's affairs is also more limited than in other chapters. *See* §§ 903; 904. In addition, Chapter 9 is by necessity a more consensual process, because the debtor generally must negotiate with its creditors. *See* § 109(c)(5).

What may make Chapter 9 most unique, however, are the five preconditions or barriers to entry that a would-be municipal debtor must satisfy to prove its eligibility for reorganization under Chapter 9:

1. The filing entity must meet the definition of “municipality”<sup>78</sup>;
2. The municipality must be “specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law”;
3. The municipality must be “insolvent”<sup>79</sup>;
4. The municipality must “desire[] to effect a plan to adjust such debts”<sup>80</sup>; and
5. The municipality must meet one of these four additional conditions: (a) the debtor must have obtained the agreement of a majority in amount of creditors to be impaired under the plan; (b) the debtor had negotiated in good faith but failed to reach an agreement with a majority of creditors<sup>81</sup>; (c) negotiations would have been

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<sup>78</sup> “The term ‘municipality’ means a political subdivision, public agency or instrumentality of a State,” and includes a town, village, borough, public improvement district, school district, or revenue producing body such as bridge or highway authority, but not the state itself and not an instrumentality of a county or local authority. § 101(40); 1 COLLIER ON BANKRUPTCY ¶ 109.04[3][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.); *see In re Hosp. Auth. of Charlton County*, 2012 Bankr. LEXIS 3042 (Bankr. S.D. Ga. July 3, 2012) (county hospital authority not municipality); *In re County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995) (county investment pool not municipality).

<sup>79</sup> Municipalities are the only debtors that are required by the Bankruptcy Code to be insolvent as a precondition for filing. § 109. “Insolvent” means the municipality is “generally not paying . . . or unable to pay its debts as they become due.” § 101(32)(C); *In re Town of Westlake*, 211 B.R. 860, 864 (Bankr. N.D. Tex. 1997).

<sup>80</sup> This has been interpreted as a requirement of good faith, meaning the municipality filed for a purpose other than to delay or avoid repayment. 1 COLLIER ON BANKRUPTCY ¶ 109.04[3][d].

<sup>81</sup> Good faith negotiations require discussion of a proposed plan, at least a plan in concept, but not necessarily a complete plan. *In re Mendocino Coast Recreational and Park Dist.*, 2012 WL 1431219 (Bankr. N.D. Cal. Apr. 22, 2012); *In re New York City Off-Track Betting Corp.*, 427 B.R. 256, 274 (Bankr. S.D.N.Y. 2010).

impracticable<sup>82</sup>; or (4) the debtor reasonably believed a creditor may attempt a transfer that is avoidable as a preference under § 547.

11 U.S.C. § 109(c); see *In re City of Vallejo*, 408 B.R. 280 (B.A.P. 9th Cir. 2009). The debtor bears the burden of proving eligibility to file Chapter 9. *Vallejo*, 406 B.R. at 289; *In re Alleghany-Highlands Econ. Dev. Auth.*, 270 B.R. 647, 649 (Bankr. W.D. Va. 2001).

Of these five preconditions to Chapter 9, the most significant barrier is the requirement that the debtor be “specifically authorized” by applicable state law.

### **California**

Because a municipality must be “specifically authorized” under state law to be a Chapter 9 debtor, states exert considerable control over which entities can file<sup>83</sup> and under what conditions.<sup>84</sup> For example, California recently revised its authorizing statute to require that a municipality must either participate in a “neutral evaluation process” with creditors or declare a “fiscal emergency” and adopt a resolution passed by a majority of its governing board to be authorized to file Chapter 9. See CAL. GOV. CODE § 53760, *et seq.* (West 2012).

The City of Stockton, California was the largest city in U.S. history to seek bankruptcy protection when it filed Chapter 9 on June 28, 2012, owing nearly \$1 billion in long-term debt. *In re City of Stockton, Cal.*, 2012 WL 2905523, at \*1 (Bankr. E.D. Cal. July 13, 2012); see Kevin Fagan, *Stockton bankruptcy filing makes history*, SAN FRANCISCO

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<sup>82</sup> In determining whether negotiation with creditors was impracticable, courts consider the number of creditors and whether delay would risk significant loss. *In re Valley Health Sys.*, 383 B.R. 156 (Bankr. C.D. Cal. 2008).

<sup>83</sup> Nearly half the states do not permit municipalities to file Chapter 9, relying instead on receivership or budget commissions. See Hillary Russ, *Analysis: Stockton, California new paradigm for struggling cities*, REUTERS, July 1, 2012 (<http://www.reuters.com/article/2012/07/01/us-stockton-bankruptcy-filing-idUSBRE86007T20120701>).

<sup>84</sup> California authorizes Chapter 9 filings by “any county, city, district, public authority, public agency, or other entity, without limitation, that is a municipality as defined in [Bankruptcy Code] Section 101(40),” but not by a “school district.” CAL. GOV. CODE § 53760.1(g) (West 2012).

CHRON., June 28, 2012 (<http://www.sfgate.com/default/article/Stockton-bankruptcy-filing-makes-history-3671895.php>). Stockton sought to comply with the requirements of California Government Code § 53760 by engaging in the neutral evaluation process. *Id.* Addressing an issue of first impression, the bankruptcy court was required to determine whether confidentiality or a privilege applied to Stockton's pre-filing neutral evaluation process between Stockton and its creditors in order to determine whether Stockton satisfied the requirements of § 53760 to be specifically authorized to file Chapter 9. *Id.*, at \*4. After reviewing California law and federal common law, the *Stockton* court concluded that no confidentiality or privilege applied to the neutral evaluation process for purposes of determining that Stockton was specifically authorized to file Chapter 9 under California Government Code § 53760, but the court did issue a protective order over some of the negotiations. *Id.*, at \*9. Creditors were given until August 23, 2012, to object to entry of the Order for Relief. [Case No. 12-32118, dkt item 450 (Bankr. E.D. Cal.)].

After Stockton, the Town of Mammoth Lakes filed Chapter 9 on July 3, 2012, to address debts arising from a breach of contract action that a creditor, Mammoth Lakes Land Acquisition, LLC ("MLLA"), had won against the Town arising from a failed resort development. *In re Town of Mammoth Lakes, Cal.*, Case No. 12-32463 (Bankr. E.D. Cal.); *see Mammoth Lakes files for bankruptcy*, L.A. TIMES, July 2, 2012 (<http://latimesblogs.latimes.com/lanow/2012/07/mammoth-lakes-bankruptcy.html>). Mammoth Lakes filed an expedited motion seeking recognition of its eligibility to file Chapter 9 and asserting that it satisfied California Government Code § 53760 by participating in a prepetition neutral evaluation process. [Case No. 12-32463, dkt item 12 (Bankr. E.D. Cal.)]. The judgment creditor, MLLA, objected to the Town's motion, seeking more time to determine whether the debtor satisfied the eligibility requirements. [Case No. 12-32463, dkt item 65]. At a hearing on July 12, 2012, the court conditionally granted



Mammoth's Lakes' motion, and creditors were given until August 24, 2012 to object to entry of the Order for Relief. [Case No. 12-32463, dkt items 86, 102]. As *Mammoth Lakes* demonstrates, more municipalities, such as the City of San Bernardino, which filed Chapter 9 on August 1, 2012<sup>85</sup>, may face challenges to their eligibility to file Chapter 9.

## **Alabama**

Like Mammoth Lakes, Jefferson County, Alabama also faced opposition to its eligibility to file Chapter 9. *In re Jefferson County, Ala.*, 469 B.R. 92 (Bankr. N.D. Ala. 2012). On November 9, 2011, Jefferson County filed the largest municipal bankruptcy in U.S. history with more than \$4 billion in debt, due largely to a failed sewer system construction and repair project. *In re Jefferson County, Ala.*, 2012 WL 2870165, at \*2-3 (Bankr. N.D. Ala. Jan. 19, 2012). Bank of New York Mellon, as indenture trustee for warrant holders of the sewer system project, challenged Jefferson County's eligibility to file Chapter 9 and argued that Alabama law only authorized Chapter 9 filings by municipalities that had outstanding bond debt. *Jefferson County*, 469 B.R. at 97-99 (It was undisputed that although Jefferson County had outstanding warrants and other debt, it did not have outstanding bond debt.).

The provision at issue, Alabama Code § 11-81-3, was located in the chapter of the statute relating to Municipal and County Bonds, and began by authorizing "the issuance or refunding or funding bonds." ALA. CODE § 11-81-3 (2012). However, the statute also permitted municipalities "to take all steps and proceedings contemplated or permitted by [Chapter 9] . . . relating to the readjustment of municipal indebtedness, and the State of Alabama hereby gives its assent thereto . . . ." *Id.* The bankruptcy court concluded that the

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<sup>85</sup> *In re San Bernardino*, Case No. 12-28006 (Bankr. C.D. Cal.); see Steven Church, Dawn McCarty & Michael Bathon, BLOOMBERG, *San Bernardino, California, Files Chapter 9 Bankruptcy Petition*, Aug. 2, 2012 (<http://www.bloomberg.com/news/print/2012-08-02/san-bernardino-california-files-for-bankruptcy-protection-2-.html>).

location of the Chapter 9 authorization provision in the chapter on bonds and its initial reference to authorizing bonds did not limit Chapter 9 to only municipalities with outstanding bond debt. *Jefferson County*, 469 B.R. at 119-120. The court therefore concluded that the Chapter 9 petition was authorized and assented to under Alabama law.<sup>86</sup>

### **Chapter 9 Not Authorized**

Other municipalities and public entities have not had the same success with Chapter 9. The capital of Pennsylvania, Harrisburg, filed a Chapter 9 petition on October 11, 2011, following authorization by the City Council. *In re City of Harrisburg, Pa.*, 465 B.R. 744, 749 (Bankr. M.D. Pa. 2011). A few days later, the Mayor of Harrisburg, the Commonwealth of Pennsylvania, and Dauphin County (in which Harrisburg is located), among others, filed opposition arguing that Harrisburg's petition had been filed without the concurrence of the Mayor and without specific authorization under Pennsylvania law. *Id.* at 749-50. The objecting parties pointed to a provision of state law passed on June 30, 2011, the last day of the legislative session, which barred all financial distressed cities in Pennsylvania from filing Chapter 9 for one year. *Id.* at 751-52, quoting 72 P.S. § 1601-D.1 (2011). The City Council argued that the temporary ban on Chapter 9 filings violated the Fourteenth Amendment to the U.S. Constitution and provisions of the Pennsylvania Constitution. *Id.* at 755-56. The bankruptcy court concluded that the ban did not violate either the federal or state Constitution and that the City Council had not been authorized to retain counsel to file the petition, and accordingly dismissed the petition. *Id.* at 764-65.

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<sup>86</sup> An objection was also raised to the eligibility of Central Falls, Rhode Island, which filed Chapter 9 on August 1, 2011. [11-13105, dkt item 214 (Bankr. D. R.I.)] The City's police and firefighters retiree associations initially objected to the City's eligibility to file Chapter 9, but subsequently withdrew their opposition [11-13105, dkt item 268], and the Order for Relief was entered on December 1, 2011. [11-13105, dkt item 272]; *see also In re City of Cent. Falls, R.I.*, 468 B.R. 36, 42 (Bankr. D.R.I. 2012).

A subsequent request for time to appeal and subsequent appeal were both denied. *See In re City of Harrisburg, Pa.*, 462 B.R. 510 (Bankr. M.D. Pa. 2011) and *City of Harrisburg, Pa. v. AFSCME Dist. Council 90*, 2012 WL 315403 (M.D. Pa. Feb. 01, 2012).

Similarly, the bankruptcy court in *In re Suffolk Regional Off-Track Betting Corporation* sustained a creditor's objection under § 109(c)(2) and dismissed a Chapter 9 filed by an off-track betting corporation ("OTB"). 462 B.R. 397 (Bankr. E.D.N.Y. 2011). The debtor had contended that it satisfied § 109(c)(2) because the legislature of Suffolk County, where the OTB was located, had authorizing its Chapter 9 filing. *Id.* at 415. However, the bankruptcy court rejected this contention, noting that although the OTB may be a municipality as defined in the Bankruptcy Code, it was not a municipality under the relevant New York State law authorizing Chapter 9 filings. *Id.* at 416, citing N.Y. Local Fin. §§ 2.00(1); 85.80 (McKinney 2011). The court added that although Suffolk County itself would be authorized under New York Local Finance Law § 85.80 to file Chapter 9, nothing in the state law permitted the county to authorize a Chapter 9 filing by the OTB, which was a separate entity. *Id.*

By contrast, the bankruptcy court in *In re New York City Off-Track Betting Corporation* found that a different OTB had specific authorization to file Chapter 9 when the Governor of New York had issued a prepetition Executive Order specifically authorizing that particular entity to file. 427 B.R. 256, 267-68 (Bankr. S.D.N.Y. 2010).

## **Forecast**

While it is unlikely that the average bankruptcy practitioner will get much experience filing Chapter 9 petitions, the recent uptick in filings and potential filings by municipalities throughout the country highlights numerous issues of which practitioners should be aware. In particular, parties on both sides need to focus on the barriers to entry

in § 109(c), especially the state law specifically authorizing a Chapter 9 filed (if one exists), as well as the non-judicial, political considerations at work in the area of Chapter 9 municipal reorganizations.

## **That's Fundamental: Dallas Bankruptcy Court Denies Recognition of Mexican Plan That Discharged Non-Debtor Guarantee Claims**

*In re Vitro, S.A.B. de C.V.*, 2012 WL 2138112 (Bankr. N.D. Tex. June 13, 2012).

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In a case that has been closely watched and is likely to have far-reaching implications, Judge Harlin D. Hale of the Bankruptcy Court for the North District of Texas (the “Bankruptcy Court”) refused to enforce a provision in Mexican glassmaker Vitro S.A.B. de C.V.’s (“Vitro’s”) confirmed Mexican plan of reorganization (the “*Concurso* Plan”) that would have extinguished hundreds of millions of dollars of guarantee claims against non-debtor subsidiaries of Vitro. *In re Vitro, S.A.B. de C.V.*, 2012 WL 2138112, at \*14 (Bankr. N.D. Tex. June 13, 2012) (hereinafter “*Vitro I*”). The Court held that Vitro’s *Concurso* Plan failed to satisfy the requirements for recognition in Vitro’s Chapter 15 case<sup>87</sup> and that enforcement was manifestly contrary to U.S. public policy. *Id.* This decision has been certified for direct appeal to the Fifth Circuit Court of Appeals.<sup>88</sup>

### **Factual Background**

Vitro, a Mexican holding company that operates one of the world’s largest glass manufacturing operations through a network of subsidiaries, issued a series of unsecured notes in 2003 and 2007 with a principal balance of \$1.225 billion. *In re Vitro, S.A.B. de C.V.*, 455 B.R. 571, 573 (Bankr. N.D. Tex. 2011) (hereinafter “*Vitro 2*”). The notes were

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<sup>87</sup> Chapter 15 is a recent addition to the Bankruptcy Code, having been added in October 2005. It is modeled on the Model Law on Cross-Border Insolvency drafted by the United Nations Commission on International Trade Law, and was intended to help harmonize global insolvency law. *See In re Ephedra Prods. Liability Litig.*, 349 B.R. 333, 333 n.1, 336 (S.D.N.Y. 2006). For additional background on Chapter 15, *see* Hon. Allan L. Gropper, *Current Developments in International Insolvency Law: A United States Perspective*, 948 PLI/COMM. 1103 (Apr. 2012).

<sup>88</sup> *In re Vitro, S.A.B. de C.V.*, 2012 WL 2367161 (Bankr. N.D. Tex. June 21, 2012). The debtor, Vitro, filed a notice of appeal June 28, 2012. [Case No. 11-33335-hdh15, dkt item 497 (Bankr. N.D. Tex.)]. The Fifth Circuit stayed the Bankruptcy Court’s Order denying recognition of the *Concurso* Approval Order pending appeal. [Case No. 11-33335-hdh15, dkt items 506, 515]. The appeal is tentatively scheduled for oral argument the week of October 1, 2012. [Case No. 12-10689 (5th Cir.)].

unsecured debt as to Vitro but were guaranteed by substantially all the assets of Vitro's numerous subsidiaries. *Id.* After Vitro missed scheduled interest payments and negotiations with noteholders broke down, several noteholders filed an involuntary petition on November 17, 2010 in the Northern District of Texas against fifteen of Vitro's U.S. subsidiaries. *Id.* at 573-75. Certain noteholders also commenced an action in New York State court in early December 2010 to enforce their guarantee claims against Vitro's subsidiaries. *Id.* at 575.<sup>89</sup> These legal actions spurred numerous rulings by various courts.

### **Procedural History**

On December 13, 2010, Vitro filed a prepackaged reorganization proceeding under Mexico's *Ley de Concursos Mercantiles*<sup>90</sup> (the "Mexican Reorganization"), and on the following day, Vitro filed a Chapter 15 petition in the Bankruptcy Court for the Southern District of New York, which was eventually transferred to the Northern District of Texas and joined with the involuntary petition. *Id.* at 575-76. Pending recognition of the Mexican Reorganization as a foreign main proceeding<sup>91</sup>, Vitro sought, and obtained, an injunction

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<sup>89</sup> The New York State court eventually ruled in favor of the noteholders, granting them a money judgment against the subsidiaries and enjoining the subsidiaries from voting in favor of Vitro's plan of reorganization. On Vitro's request, the Bankruptcy Court issued an order enforcing the automatic stay and permitted the subsidiaries to vote on Vitro's Plan. *Vitro 1*, at \*1.

<sup>90</sup> The *Ley de Concursos Mercantiles* is Mexico's Business Reorganization Act. *Vitro 2* at 575. The Mexican district court had initially dismissed the petition because it did not meet the requirements for a prepackaged proceeding under Mexican law due to the presence of intercompany claims between Vitro and its subsidiaries; however, that decision was reversed by a Mexican appellate court and the petition was reinstated. *Vitro 2* at 576.

<sup>91</sup> A "foreign main proceeding" is a proceeding in a country other than the United States where the debtor has its "center of its main interests." § 1502(4). A debtor's "center of its main interests" is determined by looking at "the location of the debtor's headquarters; the location of those who actually manage the debtor . . . ; the location of the debtor's primary assets; the location of the majority of the debtor's creditors or of a majority of the creditors who would be affected by the case; and/or the jurisdiction whose law would apply in most disputes." *In re Basis Yield Alpha Fund (Master)*, 381 B.R. 37, 47 (Bankr. S.D.N.Y. 2008); *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122, 128 (Bankr. S.D.N.Y. 2007). In *Vitro*, the Bankruptcy Court recognized the Mexican Reorganization as the foreign main proceeding, and this decision was affirmed on appeal at *In re Vitro, S.A.B. de C.V.*, 470 B.R. 408 (N.D. Tex. 2012).

pursuant to § 1519 preventing the noteholders from enforcing claims against Vitro; however, the Court refused to extend this injunction to Vitro's non-debtor subsidiaries. *Vitro 2* at 583-84.

On February 3, 2012, the Mexican federal district court handling Vitro's case issued an order approving Vitro's plan (the "*Concurso* Approval Order"). *Vitro 1*, at \*1. That Order both modified Vitro's obligations to the noteholders and also extinguished the noteholders' guarantee claims against Vitro's subsidiaries. *Id.* Vitro's foreign representatives then petitioned the Bankruptcy Court to enforce the *Concurso* Approval Order and to permanently enjoin collection efforts against Vitro and its subsidiaries. *Id.* Vitro's noteholders raised various objections to enforcement of the *Concurso* Approval Order in the Chapter 15 case, including that Vitro failed to satisfy the requirements of 11 U.S.C. § 1507(b) for recognition of the *Concurso* Approval Order, and that even if Vitro satisfied § 1507(b), the *Concurso* Approval Order was "manifestly contrary to the public policy of the United States." *Id.*, at \*10 (quoting 11 U.S.C. § 1506).

### **Issue Before the Court**

1. Whether to enforce the *Concurso* Approval Order confirming the debtor's plan of reorganization, when the plan extinguished guarantor liability for non-debtor subsidiaries which is not authorized by the Bankruptcy Code.

### **Discussion**

The Bankruptcy Court began its analysis of the *Concurso* Approval Order by noting that, in addition to the mandatory effects of recognizing a foreign main proceeding under § 1520 including imposing the automatic stay and authorizing the foreign representative to collect and manage the debtor's U.S. assets, § 1521 empowers a court to fashion "any appropriate relief" that furthers the purposes of Chapter 15 and protects the debtor's assets

and the interests of creditors. *Vitro 1*, at \*3 (quoting § 1521(a)). However, the power to grant any appropriate relief is tempered by § 1522, which permits the Court to impose conditions on such relief as may be necessary to achieve a balance between the interests of the debtor and creditors. *Id.* (citing § 1522(b); *In re Tri-Cont'l Exch. Ltd.*, 349 B.R. 627, 637 (Bankr. E.D. Cal. 2006)). Further, the Bankruptcy Court found that once a foreign main proceeding has been recognized, § 1507(a) authorizes a court to “provide additional assistance to a foreign representative,” provided such assistance is consistent with principles of comity and is designed to reasonably assure:

- 1) [the] just treatment of all holders of claims against or interests in the debtor’s property;
- 2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
- 3) prevention of preferential or fraudulent dispositions of property of the debtor;
- 4) distribution of proceeds of the debtor’s property substantially in accordance with the order prescribed by this title; and
- 5) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.

*Vitro 1*, at \*3-4 (quoting § 1507(b)).

In addition to these limitations, Chapter 15 permits a court to “refus[e] to take any action governed by this chapter if it would be manifestly contrary to the public policy of the United States.” *Id.*, at \*4 (quoting § 1506). The Bankruptcy Code does not define “public policy,” but in applying § 1506, courts generally consider whether the foreign main proceeding was “procedurally unfair” and whether recognition of the foreign proceeding would “severely hinder” the bankruptcy court’s ability to carry out fundamental statutory and constitutional rights. *Id.* (quoting *In re Ephedra Prods. Liability Litig.*, 349 B.R. 333, 335 (S.D.N.Y. 2006)). The Bankruptcy Court surveyed the case law on § 1506 and found that “those courts that have considered the public policy exception codified in § 1506 have uniformly read it narrowly and applied it sparingly.” *Id.*, at \*9 (quoting *In re Toft*, 453 B.R.



186, 195 (Bankr. S.D.N.Y. 2011)). The Bankruptcy Court agreed with the court in *Toft* that the issue is not whether the “foreign law [is] identical to U.S. law,” but whether the foreign law is “in accord with U.S. public policy.” *Id.*, citing *Toft*, 453 B.R. at 196, 198 (in which the court refused to recognize orders issued by a German court that would have permitted the foreign representative access to the debtor’s emails stored on servers in the United States because such authority exceeds the powers normally granted to a bankruptcy trustee).

The noteholders had argued that Vitro’s *Concurso* Approval Order violated U.S. public policy as well as Bankruptcy Code §§ 1507(b) and 1521. *Vitro 2*, at \*10. The Bankruptcy Court agreed. *Id.*, at \*12-14.

After rejecting the noteholders’ objections relating to Mexican procedures and process, which the Bankruptcy Court concluded should have been raised in the Mexican court<sup>92</sup>, the Court held that inclusion of third party releases in Vitro’s *Concurso* Plan precluded its enforcement in the United States under Chapter 15. *Id.*, at \*12. By providing “drastically different treatment” to the noteholders than they would have received under Chapter 11, including their rights to collect from the non-debtor guarantors, the order approving the *Concurso* Plan violated § 1507(b)(4) and could not be enforced as “additional assistance” to Vitro’s foreign representative under § 1507(a). *Id.*, at \*13. Similarly, the *Concurso* Approval Order was not “appropriate relief” under § 1521 because it “neither sufficiently protect[ed] the interests of creditors in the United States nor d[id] it provide an appropriate balance between the interests of creditors and Vitro SAB and its non-debtor subsidiaries.” *Id.*

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<sup>92</sup> The noteholders raised objections based upon the alleged unfairness or alleged corruption of the Mexican court proceedings and violations of Mexican law and process; the Bankruptcy Court found that these issues were best decided by the Mexican courts. *Vitro 1* at \*11-12. The Bankruptcy Court also concluded that the noteholders had failed to establish a valid objection based upon the *Concurso* Approval Order’s impact on the credit markets. *Id.* at \*11. However, the Court acknowledged that the noteholders had raised possibly meritorious objections based upon voting irregularities in approval of Vitro’s plan and violation of the absolute priority rule in § 1129(b). *Id.* at \*13-14.

Furthermore, the Bankruptcy Court found that the *Concurso* Approval Order violated fundamental U.S. public policy. *Id.* As evidenced by the permitted scope of releases in § 524 and as set forth in Fifth Circuit precedent, U.S. public policy largely prohibits “non-consensual non-debtor releases and permanent injunctions outside the context of mass tort claims being channeled toward a specific pool of assets.” *Id.*, at \*12, citing 11 U.S.C. § 524; *In re Pacific Lumber Co.*, 584 F.3d 229, 252 (5th Cir.2009), *rev’d on other grounds*, *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. ---, 132 S.Ct. 2065 (2012). The Bankruptcy Court noted that it had expressed “grave concerns” earlier in the case about releases for non-filing subsidiaries, but that Vitro had proceeded with the releases anyway. *Id.* The Bankruptcy Court distinguished the holding of *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685, (Bankr. S.D.N.Y. 2010), in which the court had enforced a Canadian order with limited third party releases, noting that in *Metcalfe* nearly all non-insider creditors had supported the plan, no party had timely objected to the releases, and the releases were not complete as in this case. *Id.*, at \*12-13. Therefore, the Bankruptcy Court concluded that Vitro’s *Concurso* Plan was not in accord with U.S. public policy, and the *Concurso* Approval Order was unenforceable under the public policy exception in § 1506.

## **Forecast**

In granting a temporary stay pending appeal and certifying its decision for direct appeal to the Circuit Court, the Bankruptcy Court acknowledged the “the importance of this case to the financial and legal community . . . .” *Id.*, at \*14. However, in refusing to enforce the non-debtor release in Vitro’s plan, the Bankruptcy Court recognized that “the present order would create precedent without any seeming bounds”; as one example, the Court noted that “[w]hat is to prevent this type of plan from eventually giving non-

consensual releases to discharge the liabilities of officers, directors, and any other person?”

*Id.* Chapter 15 is less than seven years old and, as a result, the scope of many of its provisions, in particular the public policy exception in § 1506, “have not yet been clearly defined.” *Id.*, at \*5. However, the Bankruptcy Court’s decision in *Vitro* further develops the expanding area of Chapter 15 case law by recognizing that certain aspects of the Bankruptcy Code – such as the limits on non-debtor releases – are so fundamental that contrary provisions in foreign plans will not be enforced against U.S. creditors.

## **Point of No Return: The Fifth Circuit Limits the Definition of Tax Returns**

*In re McCoy*, 666 F.3d 924 (5th Cir. 2012).

Matthew O. Greenberg, J.D. Candidate at Baylor Law School, February 2014,  
Judicial Extern to the Honorable Harlin D. Hale, Summer 2012

### **Factual Background**

Debtor filed Chapter 7 in 2007 and received discharge. Debtor then filed a post-discharge adversary proceeding against Mississippi Tax Commission, seeking a declaration that her 1998 and 1999 income tax debts were subject to the discharge.

### **Procedural History**

The bankruptcy court dismissed the debtor's complaint, arguing that since the debtor failed to timely file her tax returns, they did not qualify as "returns" for purposes of § 523(a)'s hanging paragraph. Debtor appealed. The United States District Court for the Southern District of Mississippi affirmed. Debtor appealed.

### **Issue Before the Court**

1. Does an income tax return that fails to comply with the applicable state filing requirements qualify as a "return" for discharge purposes?

### **Holding**

1. No, to qualify for discharge, a tax return must meet the applicable filing requirements. Here, the requirement was that it be timely filed. Since it was not timely filed, it was not a return for purposes of § 523(a) discharge.

### **Court's Analysis**

McCoy argues that the court should adopt test outlined in the pre-BAPCPA case, *In re Hindenlang*, 164 F.3d 1029 (6th Cir. 1999), *cert. denied*, 528 U.S. 810 (1999).<sup>93</sup> McCoy further argues that under the *Hindenlang* test, her tax filings constitute returns, so they

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<sup>93</sup> *In re McCoy*, 666 F.3d. 924, 927 (5th Cir. 2012).

would be discharged under 11 U.S.C. § 727.<sup>94</sup> *Hindenlang* discussed federal income tax returns, not state income tax returns.<sup>95</sup> Post BAPCPA, § 523a defines “return” for discharge purposes as:

“[A] return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.”<sup>96</sup>

In the present case, the applicable law is the Mississippi Tax Code. In Mississippi, the state tax code provides:

“Returns of individuals, estates, trusts and partnerships shall be filed on or before the fifteenth day of the fourth month following the close of the fiscal year; or if the return is filed on the basis of a calendar year, it shall be filed on or before April 15th of each year.”<sup>97</sup>

The parties agree that the preceding statute means McCoy filed her tax returns late.<sup>98</sup> The parties disagree on whether or not her late returns qualify under the “applicable nonbankruptcy law,” so as to fall outside the reach of the discharge. The Court chooses Mississippi Tax Commission’s interpretation, commenting that even though the Bankruptcy Code is “awkward” and “ungrammatical,” it should not be rendered ambiguous<sup>99</sup> though, and the court chooses a plain language approach to § 523(a).<sup>100</sup> This plain language approach applies to state taxes as well as to federal taxes.<sup>101</sup>

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<sup>94</sup> *Id.* at 926.

<sup>95</sup> *Id.* at 927.

<sup>96</sup> 11 U.S.C. § 523(a).

<sup>97</sup> MISS. CODE ANN. § 27-7-41 (West 2011).

<sup>98</sup> *McCoy*, 666 F.3d at 928.

<sup>99</sup> *Id.* at 929.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

## Forecast

This case has redefined late tax returns as not returns at all. Courts will no longer discharge tax arrears if the debtor filed the tax returns late. The effect of this case has already been felt in the courts, especially in the Fifth Circuit. Subsequent cases include: *In re Hernandez*, 2012 WL 78668 (Bankr. W.D. Tex. Jan. 11, 2012, J. Clark); *In re Green*, 2012 WL 1466515 (Bankr. W.D. Tex. Apr. 27, 2012, J. Mott); *In re Smythe*, 2012 WL 843435 (Bankr. W.D. Wash. Mar. 12, 2012); and *In re Wogoman*, 2012 WL 2562323 (B.A.P. 10th Cir. July 3, 2012).

**Classification of Claims under § 1122(a): Does the Existence of Third-Party Sources of Payment Affect Substantial Similarity?**

*Wells Fargo Bank v. Loop 76*, 465 B.R. 525 (B.A.P. 9th Cir. 2012).

Jason I. Blanchard, Esq., Law Clerk to the Honorable Alan S. Trust

In a single asset real estate (“SARE”) Chapter 11 case, as in all Chapter 11 cases, a debtor must confirm a plan of reorganization that satisfies the requirements of 11 U.S.C. § 1129.<sup>102</sup> Section 1129, as a general matter, authorizes debtors to either confirm a plan consensually under § 1129(a), or impose a plan on a dissenting class of creditors by judicial cramdown pursuant to § 1129(b). *See Bank of Am. Nat. Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 441 (1999). When pursuing cramdown under § 1129(b), SARE debtors often bifurcate the claim of an undersecured creditor into a secured claim to the extent of the value of its collateral and an unsecured deficiency claim for the balance owed, and then propose classifying the unsecured deficiency claim separately from all other unsecured claims.<sup>103</sup> *See In re L.G. Salem Ltd. P’Ship*, 140 B.R. 932, 935 (Bankr. Mass. 1992). The general issue in this SARE case, *Wells Fargo Bank v. Loop 76*, 465 B.R. 525

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<sup>102</sup> “[SARE debtors] are to be afforded no special consideration in formulating a confirmable plan.” *In re Nat’l/Northway Ltd. P’ship*, 279 B.R. 17, 29 (Bankr. Mass. 2002).

<sup>103</sup> Separate classification of an undersecured creditor’s claim from the general unsecured claim is often a dispositive factor in a debtor’s ability to confirm a plan by judicial cramdown under § 1129(b). *See In re L.G. Salem Ltd. P’Ship*, 140 B.R. at 935. This is so because it is likely that the undersecured creditor will vote to reject a debtor’s plan under which the debtor retains its property but the secured creditor’s unsecured deficiency claim is not paid in full. The general unsecured class of creditors on the other hand, composed of trade creditors, will often go along with the plan, because they have nothing to lose or because their claims are rather small and the debtor offers them considerable repayment. *Id.* Accordingly, if the trade claims are not separately classified from the secured creditor’s deficiency claim, the debtor will likely not have at least one assenting impaired class as required under 11 U.S.C. § 1129(a)(10), and the plan will not be confirmed; but, if the claims are separately classified, the general unsecured class of creditors may accept the plan and, therefore, it is possible for the plan to be confirmed. *See id.*; *see also In re Boston Post Road, Ltd., P’ship*, 21 F.3d 477, 480, 482 (2d Cir. 1994); *In re Greystone III Joint Venture*, 995 F.2d 1274, 1277 (5th Cir. 1991).

(B.A.P. 9th Cir. 2012), as is the predominant issue in many SARE cases,<sup>104</sup> is whether the claims separately classified are “substantially similar” under § 1122(a).

### **Factual Background**

The Debtor, Loop 76, a limited liability company, was formed for the sole purpose of constructing, developing, and operating an office/retail complex in Scottsdale, Arizona (the “Property”). *Id.* at 529. Debtor obtained a \$23,125,000.00 construction loan from Wells Fargo secured by the Property (the “Loan”). *Id.* Wells Fargo also obtained guarantees on the Loan from Debtor’s managing members, and their wives. *Id.* Debtor defaulted on the Loan and soon thereafter filed a petition for Chapter 11 relief. *Id.* Wells Fargo subsequently commenced an action in state court against the guarantors. *Id.*

In the Chapter 11 case, Wells Fargo filed a claim whose aggregate value exceeded the value of the Property; accordingly, Debtor’s proposed plan of reorganization called for, *inter alia*,<sup>105</sup> the separate classification of Wells Fargo’s deficiency claim and other general unsecured claims (the “Plan”). *Id.* at 529-30. Wells Fargo objected to confirmation of the Plan arguing, *inter alia*, that the Plan violated § 1122(a) because Wells Fargo’s unsecured deficiency claim was relegated to a class separate from other general unsecured claims in an attempt to gerrymander an affirmative vote on the Plan. *Id.* at 532.

After holding hearings on the claim classification issue, the bankruptcy court held that under § 1129(a) a claimant who has a third-party source of repayment for its claim is

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<sup>104</sup> See *In re Nat’l/Northway Ltd. P’ship.*, 279 B.R. at 29 (discussing how most cases in which classification of claims happens to be an issue are SARE cases); see also *In re Boston Post*, 21 F.3d 477 (discussed below).

<sup>105</sup> Although not relevant to the discussion here, it is worthwhile to mention that Debtor’s plan proposed a separate class composed of an impaired secured claim by Genesee Funding, LLC; Wells Fargo filed an objection to this claim, arguing that it consisted of a bogus transaction with a fictitious company for the purposes of creating and accepting an impaired class. See *Loop 76*, 465 B.R. at 529-530. The Bankruptcy Court overruled Wells Fargo’s objection and the B.A.P. affirmed. See *id.* at 542-44.



dissimilar from a claimant who lacks such alternative sources of payment. *Id.* at 534.

Subsequently a trial was held on confirmation of the Plan, primarily as to issues of plan feasibility, after which an order confirming the Plan was entered. *Id.* at 534-35. This appeal ensued.

### **Issue Before the Court**

1. Whether the court may consider a third-party source for recovery on a creditor's unsecured deficiency claim as a factor when determining whether that claim is substantially similar to other unsecured claims under § 1122(a).

### **Discussion**

Before the Ninth Circuit Bankruptcy Appellate Panel (“B.A.P.”) began its analysis, it discussed § 1122(a) and how Ninth Circuit courts generally determine whether claims separately classified are substantially similar. *See id.* at 536-538. Section 1122(a) states, “a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.” *Id.* at 536, quoting 11 U.S.C. § 1122(a). Section 1122(a) does not specify whether a plan must classify similar claims together; however, it specifically forbids placement of dissimilar claims into the same class. *Id.* Because the Code does not set forth criteria for determining whether claims are “substantially similar,” the B.A.P. stated that it must look to the “nature of each claim, i.e., the kind, species, or character of each category of claims.” *Id.*, quoting *In re Johnston*, 21 F.3d 323, 327 (9th Cir. 1994). If the court determines that the claims in question are not substantially similar, the analysis ends. *Id.* If the court determines that the claims are substantially similar, however, the Chapter 11 plan may only place those claims in different classes upon a showing of a business or economic justification. *Id.*, citing *In re Barakat*, 99 F.3d 1520, 1526 (9th Cir. 1996).

### ***Johnston and Barakat***

Because the bankruptcy court's holding relied on, in large part, the Ninth Circuit's decisions in *Johnston* and *Barakat*, the B.A.P. elaborated on the facts and determinations made therein. *See id.* at 537-38. In *Johnston*, the debtor filed both individual and corporate petitions under Chapter 11. *Id.* at 537. In the debtor's corporate case, a secured creditor, Steelcase, filed a secured claim pursuant to a financing agreement that was also backed by debtor's personal guaranty. *Id.* Steelcase instituted a claim in state court on debtor's personal guaranty prior to the filing of the individual Chapter 11 petition. *Id.* Because Steelcase's claim was undersecured, the debtor separately classified Steelcase's deficiency claim as an unsecured claim in its own class in debtor's individual Chapter 11 plan, which precipitated a Steelcase objection that the deficiency claim was substantially similar to the other unsecured claims. *See id.* The Ninth Circuit held that because Steelcase was differently situated from all other general unsecured claimants, their claims were not substantially similar under § 1122(a), due to the following: the Steelcase claim was partially secured by collateral of the primary obligor, the debtor's business; Steelcase was involved in litigation with the individual debtor with respect to the guaranty, unlike the other unsecured claimholders; and, Steelcase, if successful in state court could obtain full compensation prior to distribution to the other unsecured claimholders. Thus, the Ninth Circuit held that debtor's separate classification of the deficiency claim was appropriate. *Id.*, citing *Johnston*, at 328.

In *Barakat*, the Ninth Circuit considered whether the SARE debtor's separate classification of a creditor's deficiency claim from the general unsecured claimholders was permissible under § 1122(a). *Id.* at 538. The circuit court held that absent a showing of business or economic justification for separate classification, debtor's classification was

improper. *Id.* Moreover, the *Barakat* court held that *Johnston* did not apply thereto, since the circumstances present in *Johnston*, such as a third-party source of recovery, were not present. *See id.*

### **The B.A.P.’s *Loop* Analysis – A Flexible Approach to Claims Classification**

After exploring the contours of the Ninth Circuit’s decisions in *Johnston* and *Barakat*, the B.A.P. turned to Wells Fargo’s arguments against separate classification of its deficiency claim. *See id.* at 538-41. Wells Fargo argued that the bankruptcy court erred in holding that the Ninth Circuit’s holding in *Johnston* was applicable to the case at hand and that the decision in *Barakat* should control the B.A.P.’s determination of whether the claims were substantially similar under § 1122(a). *See id.* More specifically, Wells Fargo first contended that the bankruptcy court should have focused on how the deficiency claim related to assets of the debtor, rather than on issues such as the existence of personal guaranties. *See id.* at 538-39. In support of this argument, Wells Fargo proposed that courts are required to evaluate the “nature” of each claim as it relates to the assets of this debtor for § 1122(a) purposes, rather than the approach taken in *Johnston* whereby the court looked to third-party sources of recovery in making its determination. *Id.* at 539, citing *In re Los Angeles Land & Invs., Ltd.*, 282 F. Supp. 448, 453-454 (D. Haw. 1968) (a claim’s nature refers to “an analysis of the legal character or the quality of the claim as it relates to the assets of the debtor”). The B.A.P. rejected this argument holding that under *Johnston*, courts may take a “more flexible approach to claim classification,” and that classification “does not rest entirely on how it relates to assets of the debtor.” *Id.* at 540.

Wells Fargo further contended that its deficiency claim was substantially similar to the other unsecured claims, and pursuant to the holding in *Barakat*, they could not be separately classified due to lack of a business or economic justification. *Id.* at 541. The

B.A.P. disagreed. *See id.* According to the B.A.P., the circuit court in *Barakat* determined that none of the special circumstances demonstrated in *Johnston* were present; that is, there was nothing to distinguish the deficiency claim from other unsecured trade claims. *Id.*, citing *Barakat*, 99 F.3d at 1526. Here, however, the B.A.P. stated that Wells Fargo had a third-party source of recovery for its deficiency claim, i.e., the guarantors who had been sued in state court. *Id.* Moreover, this constituted a special circumstance that was not present among the other unsecured claimants. *Id.*, citing *Barakat*, 99 F.3d at 1526; *Johnston*, 21 F.3d at 328. In light of the foregoing, the B.A.P. held that bankruptcy courts may consider the existence of third-party sources of payment, including guarantors, when determining whether unsecured claims are substantially similar for classification purposes under § 1122(a), and thus affirmed Debtor’s classification of the Wells Fargo deficiency claim. *Id.*

### **A More Narrow Approach to Claims Classification**

Other circuits have taken a more limited approach to the issue of whether separately classified claims are substantially similar under § 1122(a). A notable example is the Second Circuit, as demonstrated in *In re Boston Post Road Ltd., Partnership*, 21 F.3d 477 (2d Cir. 1994). In *Boston Post Road*, the SARE Chapter 11 debtor separately classified the Federal Deposit Insurance Corporation’s (“FDIC”) deficiency claim from the other trade creditors’ unsecured claims in the debtor’s Chapter 11 plan, *id.* at 478, 483, to which the FDIC objected. *Id.* at 479. In response, debtor argued, *inter alia*, that separate classification was warranted because the FDIC’s and trade creditors’ claims arose under different circumstances<sup>106</sup> and that the debtor’s future viability depended on treating its

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<sup>106</sup> The FDIC’s claim arose under the following circumstances: the debtor mortgaged an office complex to the Connecticut Bank and Trust Company (the “Bank”); the debtor defaulted on the loan; the Bank initiated foreclosure proceedings in Connecticut state court; thereafter, the Bank became insolvent; the U.S. Comptroller of Currency seized the assets of the Bank; and the FDIC became the

trade creditors more favorable than the FDIC. *Id.* at 483. The Second Circuit held that these justifications for separate classification were invalid, since: the FDIC and the trade creditors, unsecured deficiency claims and general unsecured trade claims, respectively, enjoy similar rights and privileges under the Code; and the trade creditors, who consisted of a landscaper, property appraisers, trash removers, and accountants, were non-essential to debtor's financial future. *Id.* at 484. Thus, the debtor failed to advance a legitimate reason or a legitimate business reason supported by credible proof to warrant having separate classification of similar claims. *Id.*; but see *In re Simmons*, 288 B.R. 737 (Bankr. N.D. Tex. 2003) (permitting separate classification of student loan debt from other unsecured claims in chapter 13 because of the nondischargeability of the student loan); see also *In re Idearc, Inc.*, 423 B.R. 138 (Bankr. N.D. Tex. 2009) *aff'd on other grounds*, 2011 WL 5172544 (5<sup>th</sup> Cir. 2011) (holding in part the classification scheme in the debtor's chapter 11 plan was permissible because there was a reasonable basis therefor and all claims in each class were substantially similar).

## **Forecast**

Whether courts permit the separate classification of claims is often a dispositive factor in whether a SARE debtor can confirm a plan. The B.A.P.'s holding in *Loop* should make it easier for SARE debtors in the Ninth Circuit to confirm a plan with separate classification of unsecured claims where the mortgagee has guaranty claims against third parties, so long as all other applicable confirmation criteria can be satisfied.

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holder of the mortgage. *In re Boston Post Road*, 21 F.3d at 478. By contrast, the trade creditors class consisted of a landscaper, property appraisers, trash removers, and accountants. *Id.* at 483.

## **San Antonio Bankruptcy Court Limits Application of 11 U.S.C § 362(c)(3)(a)**

*In re Scott-Hood*, No. 11-53580, 2012 WL 2260115 (Bankr. W.D. Tex. June 18, 2012).

James G. Evans, J.D./D.C.L. Candidate at Louisiana State University, May 2013,  
Judicial Extern to the Honorable Harlin D. Hale, Summer 2012

On June 15, 2012, the United States Bankruptcy Court, Western District of Texas, San Antonio Division issued an important decision that effectively limited the scope and application of the early termination of the automatic stay under U.S.C. § 362(c)(3)(a). Judge Leif M. Clark held that for the repeat filer, early termination of the stay applies only with respect to the debtor individually, to debtor's exempt property that is collateral for debt, and with respect to certain leases, but does not terminate as to property of the estate.

### **Factual Background**

Sandra Lee Scott Hood's first bankruptcy proceeding was dismissed on August 19, 2011. Almost two months later, on October 11, 2011, Hood filed a subsequent Chapter 13 proceeding. Hood took no further action in the second filing, such as seeking an extension of the automatic stay. On March 1, 2012, JPMorgan Chase Bank ("Chase"), one of Hood's creditors, filed a Motion for Orders Confirming Termination of Automatic Stay under 11 U.S.C. § 362(j). On March 6, the court entered an Order Determining Status of Automatic Stay, and confirmed that the stay had terminated with respect to Chase, and further provided that Chase could take all legal action necessary to enforce its rights under non-bankruptcy law. On March 16, 2012, Hood filed a Motion to Reconsider and/or Vacate Order Granting Motion for Orders Confirming Termination of Stay, and for Order Determining that Stay Remains in Effect as to Actions Taken Against Property of the Estate, which was the subject of the court's decision.

## Issue Before the Court

1. Whether under § 362(c)(3)(A), the automatic stay terminates as to the property of the estate, or only as to the property of a debtor.

## Court's Analysis

In order to determine the scope of the property included in § 362(c)(3)(A), the court had to ascertain the meaning of the statute. Section 362(c)(3)(A) states that in the event that a debtor files a single or joint case within one year of a pending case that was dismissed:

(A) The stay under subsection (a) with respect to any action taken with respect to a debt or property securing such debt or with respect to any lease shall terminate with respect to the debtor on the 30<sup>th</sup> day after the filing of the later case.

11 U.S.C. § 362(c)(3)(a). The statutory language the court struggled to define was “with respect to the debtor.” The court had to determine whether the stay terminated as to only the debtor and his property, or whether it included the property of the estate as well. The court noted that this issue was especially important in the Western District because pursuant to 11 U.S.C. § 1327(b), “our confirmation orders in chapter 13 cases contain standard language to the effect that property of the estate does *not* revert in the debtor upon confirmation.”<sup>107</sup> Therefore, the court noted, “an early termination of the stay under section 362(c)(3)(a) could be meaningless if the stay does not terminate as to property of the estate.”<sup>108</sup>

The first step in the court's analysis was to review the majority and minority views regarding this very situation, as there were no decisions from the Fifth Circuit on the issue. The majority view, the court said, was that § 362(c)(3)(a) applies only to the debtor's

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<sup>107</sup> *In re Scott Hood*, No. 11-53580, 2012 WL 2260115, at \*2 (Bankr. W.D. Tex. June 18, 2012).

<sup>108</sup> *Id.* at \*3.

property, and does not terminate the stay with respect to proceedings against the estate.<sup>109</sup> The minority view was that the language of the statute was ambiguous, and in order to determine the intent of Congress, the statute should include both the debtor's property *and* the property of the estate.<sup>110</sup> The option before the court, then, was to analyze the language of the statute or to ascertain the original meaning of Congress. Rather than follow the minority view and determine the original intent of Congress, however, the court attempted to take a plain meaning approach to the statutory language, stating "resort to legislative history is unnecessary when a statute's chosen language is clear."<sup>111</sup> The court further noted that in this case, "a plain meaning approach to the statute is difficult, though not impossible."<sup>112</sup>

The crux of the court's analysis revolved around the following pieces of statutory language: "debt," "property securing such debt" and "respect to any lease." Namely, how these terms are limited by the language of the statute. The first step the court took in this analysis was to define these three categories. The court came up with the following definitions: First, as "debt" is defined in the Code as "liability on a claim," and claim is defined as "any right to payment," the court stated that "one aspect of the stay to be terminated would be any aspect that otherwise bars taking action on a debt."<sup>113</sup> Secondly, the court defined "property securing such debt" as any property that stands as collateral for debt. The court stated "It does not include unencumbered estate property. Nor does it include unencumbered property that is the debtor's property."<sup>114</sup> Lastly, the court glazed over "respect to any lease", and stated "actions taken with respect to 'any lease' are less

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<sup>109</sup> *Id.*

<sup>110</sup> *Id.* at \*4.

<sup>111</sup> *Id.* (citing *Lamie v. United States Trustee*, 540 U.S. 526, 534 (2004)).

<sup>112</sup> *In re Scott Hood*, at \*4.

<sup>113</sup> *Id.* at \*5.

<sup>114</sup> *Id.*



relevant to this case, but certainly include all the normal remedies associated with enforcing a lease, including eviction.”<sup>115</sup>

Once the court carved out these categories, it then discussed the limitations that § 362(c)(3)(a) placed upon the categories. The first limitation, the court said, is the most simple: time. Termination occurs on the thirtieth day after the second filing of the case within a year of the dismissal of the first case. The second limitation discussed by the court is “with respect to the debtor.” The court applied that language and further narrowed the aforementioned categories. As to “debt,” the court noted that “any creditor could pursue the debtor (but not the estate) to collect its debt.”<sup>116</sup> As to “property securing such debt,” the court reiterated that only collateral for a debt could be pursued by a creditor, and by adding the phrase “with respect to the debtor,” noted that collateral under the trustee could not be pursued. Finally, as to leases, the court quickly noted that a car lease or an apartment lease would “seem to be logical candidates for this subset,” but declined to comment further, stating “how much more broadly this might reach is not clear, and lies beyond the scope of this opinion.”<sup>117</sup>

One noteworthy finding the court made regarded “property securing a debt.” The court stated “only property claimed as exempt that also secures a debt could be pursued, and then only as of the time the property *becomes* exempt and so *leaves* the bankruptcy estate...usually this category does not exist as of the 30th day after filing.”<sup>118</sup> In the eyes of the court, this created a unique situation as the exemption of property occurs at least fifty days after the filing of the bankruptcy petition. This would mean that although the stay terminates after thirty days, a secured creditor cannot touch exempt property until after

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<sup>115</sup> *Id.* at \*6.

<sup>116</sup> *Id.*

<sup>117</sup> *In re Scott Hood*, at \*6, 7.

<sup>118</sup> *Id.* at \*6.

fifty days, as the property has not yet become exempt and left the estate. The court recognized this disconnect, and noted that such a reading would be in contradiction of the hopes and intent of lobbyists who pushed for the passage of the legislation. However, the court also stated that “the fact that the scope of relief is less robust than the creditors who lobbied for this legislation might have hoped for, however, is no reason to conclude that the statute is ‘truly absurd’.”<sup>119</sup> The court goes on, stating “So it often is with statutes. They fail to deliver on the expectations of those who zealously worked for their passage.”<sup>120</sup>

### **Forecast**

The court’s decision limited the scope and meaning of early termination of the stay under § 362(c)(3)(a), at least in the Western District of Texas, as only (1) property of the estate is not eligible to be pursued under the section, and (2) pursuant to 11 U.S.C. § 1327(b), no property of the estate is revested in the debtor upon confirmation. The only property in the estate that creditors can pursue will be property exempted, and even then the creditors cannot go after the property until the property is exempted, some 50 days after the filing of the case. Judge Clark’s thoughtful analysis and discussion of cases from across the country will likely result in other courts adopting his decision and could have an impact nationwide.

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<sup>119</sup> *Id.* at \*7.

<sup>120</sup> *Id.* at \*8.

## Lien Stripping in Consumer Cases

*In re McNeal*, --- Fed. Appx. ---, 2012 WL 1649853 (11th Cir. May 11, 2012) (unpublished opinion) *petition for reh'g en banc* filed June 1, 2012, and *In re Fisette*, 455 B.R. 177 (B.A.P. 8th Cir. 2011).

Jason I. Blanchard, Esq., Law Clerk to the Honorable Alan S. Trust

The Eleventh and Eighth Circuits' decisions in *McNeal*<sup>121</sup> and *Fisette*, respectively, provide an illustrative overview of how courts widely diverge in their analysis of lien strip offs. *See, e.g., In re McNeal*, --- Fed. Appx. ---, 2012 WL 1649853 (11th Cir. May 11, 2012) (unpublished opinion) *petition for reh'g en banc* filed June 1, 2012; *In re Fisette*, 455 B.R. 177 (B.A.P. 8th Cir. 2011). For terminology purposes, it is important to highlight that a consensual mortgage that is not supported by any value in the collateral is referred to as "wholly unsecured"; a "strip off" refers to the avoidance of a wholly unsecured mortgage lien. *See In re Miller*, 462 B.R. 421, 425 (Bankr. E.D.N.Y. 2011) (Trust, J.). On the other hand, "stripping down" is the process of bifurcating a secured creditor's claim into both a secured claim to the extent of the fair market value of the collateral available to secure the lien position, and an unsecured claim for the remaining balance of the claim. *Id.* In the current real estate market, the frequency with which consumer debtors seek to strip off liens has caused courts to consider whether and under what circumstances to permit them, with results varying widely from circuit to circuit.

For instance, in *McNeal*, the Eleventh Circuit, in what has been viewed as a substantial departure from the Supreme Court's decision in *Dewsnup v. Timm*, 502 U.S. 410 (1992) – which held that a Chapter 7 debtor could not strip down a partially secured lien under § 506(d) – determined that a Chapter 7 debtor could strip off a wholly unsecured

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<sup>121</sup> *In re McNeal* is an unpublished decision of the Eleventh Circuit Court of Appeals and, therefore, is "not considered binding precedent, but [it] may be cited as persuasive authority." Eleventh Circuit Rules 32-2; 32-3 (Dec. 2010) (<http://www.ca11.uscourts.gov/documents/pdfs/BlueAUG12.pdf>); *see also* FED. R. APP. P. 32.1.

junior lien. *See In re McNeal*, 2012 WL 1649853, at 1-2 (discussing 11 U.S.C. § 506(d) (2011)). Moreover, courts have reached opposite conclusions on whether a Chapter 20 debtor<sup>122</sup> may strip off a wholly unsecured residential mortgage lien under a Chapter 13 plan.<sup>123</sup> The Eighth Circuit in *Fisette* held that Chapter 20 debtors are in fact permitted to strip off wholly unsecured liens and that strip off becomes effective upon the completion of debtors' obligations under a plan, despite ineligibility for receipt of a Chapter 13 discharge. *See In re Fisette*, 455 B.R. 177, 187.

### **Strip Offs in Chapter 7**

In *McNeal*, the Chapter 7 debtor sought to strip off a junior underwater mortgage on her home pursuant to 11 U.S.C. §§ 506(a) and (d). *McNeal*, 2012 WL 1649853, at \*1. The debtor argued that because the senior mortgage exceeded the fair market value of her home, the junior mortgage was wholly unsecured under § 506(a), and thus void under § 506(d). *Id.* While the bankruptcy court denied the debtor's strip off motion, holding that *Dewsnup* applied to lien strip offs under § 506(d), and the district court affirmed, the circuit court reversed and remanded.

The Eleventh Circuit first reasoned that the junior lien was both an "allowed" claim under § 502<sup>124</sup> and wholly unsecured under § 506(a). *Id.* Section 506(a) provides that:

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<sup>122</sup> "In a 'chapter 20' case, a debtor who previously received a chapter 7 discharge later files a chapter 13 case; such a debtor is ineligible to receive a chapter 13 discharge if he or she received a chapter 7 discharge 'in a case filed under chapter 7 . . . during the 4-year period preceding' the filing of the chapter 13 case, pursuant to 11 U.S.C. § 1328(f)(1)." *Miller*, 462 B.R. at 425, n.2.

<sup>123</sup> More precisely stated, courts are divided as to whether a wholly unsecured mortgage lien is avoided upon Chapter 13 discharge or upon plan completion. According to some courts, the lien is avoided upon discharge; thus, a debtor who is ineligible for discharge would not be permitted to avoid the lien. *See id.* at 428-429. While other courts have held that a Chapter 20 debtor's ineligibility for Chapter 13 discharge does not affect that debtor's ability to avoid a lien, because the lien is avoided upon plan completion. *Id.*

<sup>124</sup> Section 502 provides in relevant part, "[a] claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general

[a]n allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest ... in such property ... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim.

*Id.* at n.2, quoting 11 U.S.C. § 506(a). Accordingly, to determine whether this “allowed,” but unsecured claim was voidable, the circuit court looked to § 506(d), which states that “[t]o the extent that a lien secures a claim against a debtor that is not an allowed secured claim, such claim is void.” *See id.*, quoting 11 U.S.C. § 506(d).

Therefore, in determining whether the wholly unsecured lien was void under § 506(d), the court looked to both Supreme Court and Eleventh Circuit precedent. *See id.* In *Dewsnup*, the Supreme Court held that the debtor could not strip down a partially unsecured lien in a Chapter 7 case, *id.*, citing 502 U.S. at 410; however, most courts, including those within the Eleventh Circuit, have held that *Dewsnup*’s holding extends to prohibiting strip offs in Chapter 7. *Id.*, citing *Talbert v. City Morg. Serv.*, 344 F.3d 555 (6th Cir. 2003) (“a Chapter 7 debtor may not use 11 U.S.C. § 506 to ‘strip off’ an allowed junior lien where the lien exceeds the fair market value of the real property”); *Ryan v. Homecomings Fin. Network*, 253 F.3d 778 (4th Cir. 2001) (“a Chapter 7 debtor may not use § 506(d) to strip off an allowed, wholly unsecured consensual junior lien from real property”); *Laskin v. First Nat’l Bank of Keystone*, 222 B.R. 872 (B.A.P. 9th Cir. 1998); *see also In re Enewally*, 386 F.3d 1165, 1169 (9th Cir. 2004) (“after *Dewsnup*, courts have refused to allow lien stripping in Chapter 7 cases”).

The Eleventh Circuit, nevertheless, citing to pre-*Deswnup* Eleventh Circuit case law, *Folendore v. United States Small Bus. Admin.*, 862 F.2d 778 (11th Cir. 1989), determined that an “allowed” claim that was wholly unsecured was voidable pursuant to

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partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.” 11 U.S.C. § 502.

the plain language of § 506(d). *Id.*, at \*2. The court reasoned that “because *Dewsnup* disallowed only a ‘strip down’ of a partially secured mortgage lien and did not address a ‘strip off’ of a wholly unsecured lien” it was not on point, and accordingly not applicable to the case before it. *Id.* As such, the Eleventh Circuit elected to follow its pre-*Dewsnup* precedent and held, consistent with *Folendore*, that the junior mortgage lien was voidable under the plain language of § 506(d), and thus could not be stripped off. *Id.* A minority of cases outside the Eleventh Circuit would concur. See *In re Smoot*, 465 B.R. 730 (Bankr. E.D.N.Y. 2011); *In re Lavelle*, 2009 Bankr. LEXIS 3795 (Bankr. E.D.N.Y. 2009).

### **Strip Offs in Chapter 20**

In *Fisette*, the Chapter 20 debtor sought to strip off two wholly unsecured junior mortgage liens on his principal residence and pay these junior liens as unsecured claims through his Chapter 13 plan. *In re Fisette*, 455 B.R. 177, 179-80 (B.A.P. 8th Cir. 2011). After the bankruptcy court denied confirmation of the debtor’s plan and after debtor’s request for leave to appeal from the bankruptcy court’s order was also denied, the debtor filed an amended plan where the junior mortgagees’ claims would be treated as secured. *Id.* at 180. The bankruptcy court then confirmed the amended plan over the objection of the debtor which prompted the debtor to appeal. *Id.*

As a starting point, the Bankruptcy Appellate Panel (“B.A.P.”) looked to the interaction of two Code provisions, §§ 506(a)<sup>125</sup> and the antimodification clause of

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<sup>125</sup> As discussed above, § 506(a) states in relevant part, that:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest, ..., is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, ..., and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim.

11 U.S.C. § 506(a).

1322(b)(2),<sup>126</sup> and the Supreme Court’s analysis thereof in *Nobelman v. American Savings Bank*, 508 U.S. 324 (1993), to first determine whether the Chapter 20 debtor could strip off a wholly unsecured lien on the debtor’s premises. *Id.* at 181. Section 506(a) sets forth how the status of secured claims are to be determined (through valuation of the security interest), while § 1322(b)(2) authorizes a Chapter 13 plan to “modify the rights of holders of secured claims *other than* a claim secured only by a security interest in real property that is the debtor’s principal residence, or of holders of unsecured claims....” 11 U.S.C. § 1322(b)(2) (emphasis added). Moreover, *Nobelman* held that a debtor could not strip down the unsecured portion of a creditor’s undersecured claim on the debtor’s principal residence, because § 1322(b)(2)’s antimodification provision applied to both the secured and unsecured portions of the claim. *Fisette*, 455 B.R. at 182. While the Eighth Circuit acknowledged the Supreme Court’s holding in *Nobelman*, the B.A.P. stated that *Nobelman* did not answer, however, whether a debtor could strip off a wholly unsecured lien on the debtor’s principal residence. *Id.* The court, nevertheless, found *Nobelman*’s analysis instructive. *See id.*

The B.A.P. went on to explain that whether a lien claimant is the holder of a “secured claim” or an “unsecured claim” under § 506 (a) depends on whether the subject security interest has any actual “value.” *Id.* at 183, citing *In re Lane*, 280 F.3d 663, 669 (6th Cir. 2002). Further, § 1322(b)(2) applies only to holders of “secured claims,” a term of art under § 506(a) which includes both secured and undersecured claims. *Id.* at 182. Thus, in *Nobelman*, the creditor was in fact still the holder of a secured claim under § 506(a) because it was still partially secured by value in the collateral, and as such eligible for § 1322(b)(2) antimodification protection. *Id.* at 182. In contrast, in *Fisette* the value of the debtor’s principal residence was less than the claim of the senior lienholder, and as such

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<sup>126</sup> Section 1322(b)(2) is colloquially referred to as the antimodification provision of Chapter 13. *See, e.g., In re McDonald*, 205 F.3d 606 (3rd Cir. 2000).

there was no value securing the junior mortgage liens. *Id.* at 183. Accordingly, the court concluded that the junior lienholders claims were unsecured under § 506(a) and thus § 1322(b)(2)'s antimodification provision was inapplicable. *Id.*

The B.A.P. then considered whether the debtor's ineligibility for Chapter 13 discharge under § 1328(f) barred him from permanently stripping off the wholly unsecured liens on his principal residence. *Id.* at 184-185. The B.A.P. recognized that some courts prohibit a permanent strip off on a principal residence where the debtor is ineligible for discharge, (*see, e.g., In re Victorio*, 454 B.R. 759 (Bankr. S.D. Cal. 2011); *In re Gerardin*, 447 B.R. 342 (Bankr. S.D. Fla. 2011); *In re Fenn*, 428 B.R. 494 (Bankr. N.D. Ill. 2010)); while others permit permanent strip offs despite the debtor's ineligibility for a discharge. *Id.* at 185, citing *In re Jennings*, 454 B.R. 252 (Bankr. N.D. Ga. 2011); *In re Okosisi*, 451 B.R. 90 (Bankr. D. Nev. 2011); *In re Fair*, 450 B.R. 853 (E.D. Wis. 2011); *In re Hill*, 440 B.R. 176 (Bankr. S.D. Cal. 2010); *see also In re Miller*, 462 B.R. 421 (Bankr. E.D.N.Y. 2011)(Trust, J.). Given the split in the case law, the B.A.P. looked to the language of various Code provisions in making its determination. *See id.* at 185-86.

Looking to § 1328(f)(1)'s discharge prohibition, the B.A.P. stated that nothing therein limits a Chapter 13 debtor's ability to modify a wholly unsecured lien under § 1322(b)(2). Further, the B.A.P. found that the Code did not otherwise limit a Chapter 20 debtor from enjoying the rights granted to Chapter 13 debtors, including those sections governing plan confirmation, "[sections] 1325(a) and (b) [set] forth numerous requirements for confirmation of a chapter 13 plan, [but] nothing in § 1325 conditions confirmation on the debtor being eligible for a discharge." *Id.* at 185, quoting *In re Tran*, 431 B.R. 230, 235 (Bankr. N.D. Cal. 2010). *Id.* Therefore, the court agreed with the latter group of cases, holding that the strip off of a wholly unsecured lien on a debtor's principal residence is



effective upon completion of debtor's obligations under the debtor's Chapter 13 plan and is not affected by a debtor's ineligibility to receive a Chapter 13 discharge. *Id.* at 186.

### **Forecast**

As demonstrated in *McNeal* and *Fisette*, courts regularly engage in a meticulous interpretation of relevant Code sections when evaluating lien stripping motions; as a result, courts from circuit to circuit, and even courts within the same circuit and same district, sometimes reach divergent conclusions.

## **Tax-Exempt IRAs Are Exemptible in Bankruptcy Under § 522(d)(12)**

*In re Chilton*, 674 F.3d 486 (5th Cir. 2012).

The debtors in this case listed an inherited individual retirement account (“IRA”) worth \$170,000 as an asset in their Chapter 7 bankruptcy petition and sought to exempt those funds pursuant to 11 U.S.C. § 522(d)(12). *In re Chilton*, 674 F.3d 486, 487 (5th Cir. 2012). The trustee for the bankruptcy proceeding objected to the exemption on the grounds that inherited IRAs do not qualify for the exemption. *Id.* In response, the debtors converted their filing to a Chapter 13 bankruptcy, at which time the trustee again objected to the claimed exemption. *Id.* at 488. The bankruptcy court sustained the trustee’s objection, but the district court reversed. *Id.*

Addressing an issue of first impression, the Fifth Circuit Court of Appeals affirmed the district court’s decision, holding that inherited IRAs satisfy the two requirements of § 522(d)(12): (1) that the amount the debtor seeks to exempt must be from retirement funds, and (2) that those funds must be in an account that is exempt from taxation under section 401, 403, 408, 408A, 414, or 501(a) of the Internal Revenue Code. *Id.* The Fifth Circuit, in confirming that inherited IRAs qualify as “retirement funds,” used a plain meaning interpretation of that term. *Id.* This interpretation is supported by most courts that have considered the issue. *Id.* at 489.

The Fifth Circuit then decided that inherited IRAs are exempt from taxation by 26 U.S.C. § 408(e). *Id.* at 489-90. Section 408’s expansive language indicated to the court that it is the exempting section for *all* individual retirement accounts, including inherited IRAs. *Id.* at 490. On these grounds, the appellate court confirmed that an inherited IRA satisfies the requirements of § 522(d)(12) and is exempt and is therefore not considered property of the estate. *Id.*

## **No “Whole Business Enterprise” Exception to Definition of SARE**

*In re Meruelo Maddux Properties, Inc.*, 667 F.3d 1072 (9th Cir. 2012).

The Ninth Circuit affirmed a determination that a subsidiary of a real property development conglomerate is a single asset real estate (“SARE”) debtor, as defined in 11 U.S.C. § 101(51B), if it proceeds with its bankruptcy as a separate financial and legal entity. *In re Meruelo Maddux Properties, Inc.*, 667 F.3d 1072, 1076-77 (9th Cir. 2012). In *Meruelo Maddux*, debtor, MMP Hill, a subsidiary of parent real estate developer Meruelo Maddux Properties, solely owned a 90-unit apartment complex. In March 2009, the parent company and its fifty-three subsidiaries, including the debtor, filed separate voluntary Chapter 11 petitions. *Id.* at 1075. The bankruptcy court jointly administered but did not substantively consolidate the cases. *Id.* Bank of America, a creditor with a secured interest in MMP Hill’s complex, requested relief from the automatic stay, pursuant to 11 U.S.C. §§ 101(51B) and 362(d)(3), based on its claim that MMP Hill was a SARE debtor. *Id.* at 1074.<sup>127</sup> Debtor contested the SARE classification, arguing that § 101(51B) was not intended to include entities of complicated financial and organizational structures. *Id.*

The bankruptcy court agreed, holding that “MMP Hill is part of a whole business enterprise to which it would not be appropriate to apply the [SARE] provisions.” *Id.* at 1077. The district court reverse, finding that MMP Hill was a SARE debtor because the company’s decision not to substantively consolidate the bankruptcies left the apartment complex as the debtor’s only asset. *Id.* The Ninth Circuit affirmed the district court, accepting the debtor’s legal status as separate and distinct from the parent, and reasoning that because this debtor entity satisfied the definition of a SARE in §101(51B), designating debtor a SARE would not produce a result contrary to the Congressional intent.

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<sup>127</sup> Section 362(d)(3) requires a SARE debtor to file a plan of reorganization that has a reasonable possibility of being confirmed in a reasonable time or commence monthly payments to the secured creditor within 90 days of the petition date.

## Second Circuit Limits the § 524(g) Channeling Injunction for Parent Companies

*In re Quigley Co., Inc.*, 676 F.3d 45 (2d Cir. 2012).

Bryan J. Hall, Esq., Law Clerk to the Honorable Alan S. Trust

The Second Circuit has recently clarified the limits of § 524(g) channeling injunctions<sup>128</sup> for asbestos litigation, holding that a § 524(g) injunction did not bar litigation against the non-debtor parent company, where the suit alleged the parent was independently liable for the alleged harm and not by reason of its involvement with the debtor, even though such suits may ultimately impact property of the estate. *In re Quigley Co., Inc.*, 676 F.3d 45, 62 (2d Cir. 2012).

Quigley, a manufacturer of asbestos products, was acquired by Pfizer, Inc., in 1968. *Id.* at 47. After the acquisition, some of Quigley's products were marketed under Pfizer's name, logo and trademark. *Id.* A group of plaintiffs allegedly injured by asbestos exposure sued Pfizer in Pennsylvania, arguing that Pfizer was directly liable for their harm as the "apparent manufacturer" of the asbestos products, based upon Pfizer's name, logo and trademark appearing on the products. *Id.* at 49. Subsequently, while facing a number of asbestos related lawsuits, Quigley filed Chapter 11 in 2004, and it sought and obtained two injunctions from the bankruptcy court barring asbestos suits from continuing while Quigley sought to reorganize. *Id.* at 48. The second injunction was issued in contemplation of confirmation of a plan of reorganization, and tracked the language of 11 U.S.C. § 524(g) and purported to bar suits against Pfizer for the conduct of or claims against Quigley arising by reason of Pfizer's ownership of Quigley, involvement in its management, provision of

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<sup>128</sup> A channeling injunction is designed to preserve property of the debtor's estate by directing all personal injury suits against the debtor and certain third parties arising from asbestos exposure to a specific pool of assets, generally insurance policies in which both the debtor and third parties have an interest. See Deborah E. Greenspan and Fredric Brooks, *Non-Debtor Injunctions Barring Future Asbestos Claims Under Bankruptcy Code §524(g)*, N.Y.L.J. July 16, 2012.

insurance, or involvement in other corporate or financial transactions with Quigley. *Id.* at 48.

On Pfizer's request, the bankruptcy court later interpreted this second injunction as barring the Pennsylvania asbestos suit against Pfizer from continuing. *Id.* at 49. The district court reversed, finding that the Pennsylvania suit was based on Pfizer's independent liability as an apparent manufacturer, not its liability for claims against Quigley. *Id.* at 50.

The Second Circuit began by determining that the bankruptcy court had constitutional and statutory authority to issue the injunction under *Stern v. Marshall*, 131 S.Ct 2594 (2011), because the injunction protected assets of the bankruptcy estate and did not involve entry of a final judgment on a common law claim. *Id.* at 52. The court also rejected the notion that the suit against Pfizer was too attenuated to confer jurisdiction, finding that the exercise of bankruptcy jurisdiction was appropriate where the suit against Pfizer could ultimately be paid from property of Quigley's estate. *Id.* at 53-54, 57-58.

While finding that the bankruptcy court had jurisdiction to issue the injunction, the Second Circuit concluded that the injunction – which tracked the statutory language of § 524(g) – did not enjoin the Pennsylvania suit from proceeding against Pfizer. *Id.* at 62. The Second Circuit found that the language of § 524(g)(4)(A)(ii) only barred suits where the non-debtor's alleged liability arises “as a legal consequence of one of the four relationships between the debtor and the third party enumerated in [§ 524(g)(4)(A)(ii)](I) through (IV).” *Id.* Because Pfizer's alleged liability arose from its own independent liability as an apparent manufacturer, the Second Circuit concluded that § 524(g), and therefore the bankruptcy court's injunction, did not bar the suit from proceeding against Pfizer. *Id.*

## **Fanning the Chapter 7 Fire: Easterbrook Construes Statutorily**

*Sunbeam Products, Inc. v. Chicago American Mfg., LLC*, 2012 WL 2687939 (7th Cir. July 09, 2012).

Matthew O. Greenberg, J.D. Candidate at Baylor Law School, February 2014,  
Judicial Extern to the Honorable Harlin D. Hale, Summer 2012

Lakewood Engineering & Manufacturing Co. contracted with Chicago American Manufacturing (“CAM”) to produce fans under Lakewood’s patents and trademarks. *Sunbeam Products, Inc. v. Chicago American Mfg., LLC*, 2012 WL 2687939, at \*1 (7th Cir. July 09, 2012). After Lakewood’s creditors file an involuntary bankruptcy, the Chapter 7 trustee rejected the executory portion of the Lakewood-CAM contract. *Id.* Sunbeam Products purchased the debtor’s assets and initiated a suit when CAM continued to produce fans after the trustee rejected the contract. *Id.* Sunbeam claimed that rejection of the contract rescinded permission to use Lakewood’s trademarks, citing the Fourth Circuit’s decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir.1985). *Id.* CAM alleged that rejection is not a recession and the trademark use was permitted. *Id.* The bankruptcy court agreed. *Id.*

Writing for the Seventh Circuit panel, Judge Easterbrook channeled Justice Scalia and hit back at *Lubrizol* with a statutory construction-laced argument. *Id.* at \*2-4. The limited definition of “intellectual property” in § 101(35a), along with the omission of trademarks in §365(n) indicates Congressional intent to omit trademarks, Easterbrook contended. *Id.* at \*2. Easterbrook quickly dismissed the bankruptcy’s judge’s “equitable grounds” rationale, noting the Supreme Court’s commentary in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065, 2073 (2012) [discussed *supra* at page 5], that the Bankruptcy Code is unruly and judges have an obligation to interpret the Bankruptcy Code using well-established principles of statutory construction. *Id.* While not reversing the bankruptcy court’s decision, Judge Easterbrook affirmed on other grounds, finding that

§ 365(g) clearly states that the rejection of an executory contract constitutes a breach of contract. *Id.* at \*2-3. At this point, the underlying issue is a simple contract one. *Id.* at \*3. Outside the bankruptcy context, a licensor's breach does not terminate the right to use intellectual property. *Id.* A licensor cannot breach the contract in order to remove the licensee's rights to the license. Therefore, Judge Easterbrook concluded, in the bankruptcy context, rejection of the executory contract under § 365(g) in effect breached the contract, leaving the intellectual property license and trademark use in place. *Id.* at \*4.

## **LLC Managing Members Are “Insiders” for One-Year Preference Reach-back**

*In re Longview Aluminum, L.L.C.*, 657 F.3d 507 (7th Cir. 2011).

Bryan J. Hall, Esq., Law Clerk to the Honorable Alan S. Trust

The Seventh Circuit Court of Appeals has held that a managing member of a Delaware Limited Liability Company (“LLC”) fits the definition of an “insider” for purposes of the one-year preferential transfer recovery period in 11 U.S.C. § 547(b)(4)(B), even when that member has been temporarily prevented from accessing the LLC’s books and records and when the transfer sought to be avoided was the product of arm’s-length dealing. *In re Longview Aluminum, L.L.C.*, 657 F.3d 507 (7th Cir. 2011). In *Longview*, Dominic Forte, a 12% interest holder in the LLC, had sued the LLC over its refusal to allow him access to the LLC’s books and record and his exclusion from decision making. *Id.* at 508. The parties settled and Forte was paid \$200,000 in partial settlement more than 90 days prepetition but within one year of the LLC filing; Forte was also paid \$15,000 for attorney’s fees within 90 days of the petition date. *Id.* at 508-09. Longview’s Chapter 7 Trustee sought to avoid both transfers as preferential under § 547(b). *Id.* at 509.

In affirming both the bankruptcy and district courts, the Seventh Circuit first noted that when, as in this case, a party does not meet the literal definition of “insider” in § 101(31), courts look to whether the party holds a position substantially similar to one specified in § 101(31), or whether the party had a sufficiently close relationship to the debtor to warrant closer scrutiny than an arm’s-length transaction. *Id.* Applying this analysis, the Seventh Circuit followed several other courts which had concluded that members of an LLC hold a position substantially similar to the “insiders” enumerated in § 101(31). *Id.* at 509-10, citing *In re Krehl*, 86 F.3d 737, 741 (7th Cir. 1996); *In re Pearson*, 2010 WL 3956762, at \*3 (Bankr. M.D. Pa. 2010); *In re Die Fliegermaus LLC*, 323 B.R. 101,



111 (Bankr. S.D.N.Y. 2005); *In re Barman*, 237 B.R. 342, 348–49 (Bankr. E.D. Mich. 1999). The Seventh Circuit also found that under Delaware corporate and LLC law, a managing member of an LLC is analogous to a director of a corporation, which is an enumerated within § 101(31)(B). *Longview*, 657 F.3d at 510, citing 8 DEL. CODE ANN. C. § 141(a) (2010) and 6 DEL. CODE ANN. § 18-402. Additionally, Longview’s LLC agreement specifically granted its members management authority. *Longview*, 657 F.3d at 510. The court rejected Forte’s argument that he had no control over the LLC, finding that the suspension of his access to the LLC’s books and records was temporary and that, unlike cases cited by Forte, he had not relinquished his position of control until after the preferential transfers had been made. *Id.* at 510-11. The Seventh Circuit also rejected Forte’s argument that insider status requires a closer than arm’s-length transfer, finding that a party may satisfy the definition of “insider” either based on substantial similarity to an enumerated position or as a result of a closer than arm’s-length relationship. *Id.* at 511. Accordingly, the Chapter 7 Trustee could avoid under § 547(b) all transfers from the debtor to Forte within one year of the petition date. *Id.*

## **“Fee-Only” Chapter 13 Plans Are Not Per Se Filed in Bad Faith**

*In re Puffer*, 674 F.3d 78 (1st Cir. 2012).

Jason I. Blanchard, Esq., Law Clerk to the Honorable Alan S. Trust

A “fee-only” Chapter 13 plan is one in which the majority of plan payments are directed toward professional fees to attorneys and the commissions for the trustee, and effectively provide nearly nothing to general unsecured creditors; courts have widely diverged on the question of whether fee-only plans are permissible under the Bankruptcy Code. *In re Puffer*, 674 F.3d 78, 79-81 (1st Cir. 2012). The First Circuit Court of Appeals in *Puffer*, in a case of first impression, recently held that fee-only Chapter 13 plans are not per se filed in bad faith under 11 U.S.C. § 1325, and that courts must consider whether a debtor has demonstrated “special circumstances” when measuring whether a debtor’s fee-only Chapter 13 plan was filed in good faith. *Id.* at 82-84. The *Puffer* decision discusses cases such as *In re Paley*, 390 B.R. 52, 59 (Bankr. N.D.N.Y. 2008); *In re Dicey*, 312 B.R. 456, 459-60 (Bankr. D.N.H. 2004); *In re Elkins*, 2010 WL 1490585, at \*3 (Bankr. E.D.N.C. Apr. 13, 2010); and *In re Molina*, 420 B.R. 825, 829-33 (Bankr. D.N.M. 2009).

In *Puffer*, the low income debtor was advised by his attorney that he could either file a petition under Chapter 7 or Chapter 13. *Id.* at 80. The attorney further advised the debtor that if he chose to file under Chapter 7, the attorney’s services would require a one-time payment of \$2,300.00 in legal fees in advance of filing the case, or the attorney would not be able to represent the debtor in a Chapter 7 case. *Id.* On the other hand, the debtor’s attorney explained that if the debtor chose to file under Chapter 13, the debtor could pay the attorney’s projected legal fees of \$4,100.00 through the debtor’s Chapter 13 plan over a period of thirty six months. *Id.* Given the debtor’s dire financial circumstances, he chose the latter option. *Id.* The bankruptcy court rejected debtor’s Chapter 13 plan, holding that

neither the debtor's Chapter 13 petition nor the plan was proposed in good faith under § 1325(a)(3) and (7).<sup>129</sup> *Id.* at 81. On an intermediate appeal, the district court affirmed. *Id.* The debtor appealed this determination. *Id.*

The First Circuit began its analysis by discussing the concept of good faith under § 1325 and its application pursuant to First Circuit precedent. *See id.* The court first highlighted that an adjudication of good faith is conducted under a totality of the circumstances approach, which is a process of balancing various factors, not a mechanical checklist. *Id.* at 82. Moreover, the court emphasized that the concept of good faith is one that “derives from equity,” (*Id.* citing *In re Capitol Food Corp. of Fields Corner*, 490 F.3d 21, n.1 (1st Cir. 2007)), that is “peculiarly insusceptible to per se rules.” *Id.*, citing *Johnson v. Spencer Press of Me., Inc.*, 364 F.3d 368, 383 (1st Cir. 2004). However, the court acknowledged that fee-only plans are problematic by their very nature; that is, they leave a “majority of debts unsatisfied” and are particularly “vulnerable to abuse by attorneys” because attorneys may seek to advance their own interests over that of the debtors they represent. *Id.* at 82-83. Accordingly, while the court cautioned that its opinion should not be read as a “paean” for fee-only plan filers, it crafted a new rule mandating that fee-only plan proponents must demonstrate “special circumstances” to justify submission of fee-only plans; however, the court did not identify what would constitute “special circumstances.” *See id.* at 83. Against this backdrop, the court remanded the case to the bankruptcy court to determine whether “special circumstances” existed to justify debtor's fee-only Chapter 13 plan. *Id.*<sup>130</sup>

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<sup>129</sup> Although the First Circuit only addressed bad faith as it related to debtor's proposed plan, the court's holding is also applicable to the filing of the Chapter 13 petition. *In re Puffer*, 674 F.3d at 81, n.2.

<sup>130</sup> Note that Circuit Judge Lipez concurred in the judgment, but concluded that a “special circumstances” approach should not supplant the totality of the circumstances analysis, nor should it be a threshold limitation when determining plan good faith. *See id.* at 87-88.

## **Prepetition Intercreditor Assignment of Voting Rights Unenforceable**

*In re SW Boston Hotel Venture, LLC*, 460 B.R. 38 (Bankr. D. Mass. 2011).

Norah M. Roth, Law Clerk to the Honorable Alan S. Trust

The Bankruptcy Court for the District of Massachusetts held in *In re SW Boston Hotel Venture, LLC*, that a provision of an intercreditor agreement that assigned voting rights from a junior creditor to a senior creditor was unenforceable. 460 B.R. 38, 52 (Bankr. D. Mass. 2011). In this Chapter 11 case, the two largest secured creditors, Prudential Insurance and the City of Boston, had a prepetition agreement purporting to assign the City's voting rights in a bankruptcy reorganization to Prudential. *Id.* at 51–52. The City voted in favor of the Debtor's plan of reorganization, while Prudential voted against the plan on the City's behalf. *Id.* at 51.

Although subordination agreements are generally enforceable under 11 U.S.C. § 510(b), the court held that such agreements cannot nullify substantive rights such as the City's right to vote on the plan. *Id.* at 52. The Court, acknowledging a split in authorities, sided with Judge Wedoff's decision in *203 N. LaSalle Street P'ship*, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000), holding a subordination agreement's assignment of voting rights in a future Chapter 11 case contrary to 11 U.S.C. § 1126(a), and found the City's prepetition assignment of voting rights to Prudential under the intercreditor agreement unenforceable. *Id.*; see also *In re Boston Generating, LLC*, 440 B.R. 302, 321 (Bankr. S.D.N.Y. 2010) (holding the language of a prepetition intercreditor agreement did not waive the junior creditor's right to object to a section 363 sale of the debtor's assets). The Court rejected the contrary holding of *Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006) (upholding a prepetition subordination agreement authorizing a lender to vote on a

creditor's claims in a bankruptcy proceeding), finding the decision of the *LaSalle* court to be more persuasive.

## NY Court Questions but Grants U.S. Trustee's Motion to Change Venue

*In re Houghton Mifflin Harcourt Pub. Co.*, --- B.R. ---, 2012 WL 2368547 (Bankr. S.D.N.Y. June 22, 2012).

Jason I. Blanchard, Esq., Law Clerk to the Honorable Alan S. Trust

The Bankruptcy Court for the Southern District of New York recently held that where venue of a case is not proper under 28 U.S.C. § 1408, courts are required to transfer the case upon application by a party with standing, despite the resulting inconvenience to the parties and prejudice to the interests of creditors. *In re Houghton Mifflin Harcourt Pub. Co.*, --- B.R. ---, 2012 WL 2368547 at \*11 (Bankr. S.D.N.Y. June 22, 2012). However, the court determined that it could approve the debtor's prepackaged Chapter 11 plan<sup>131</sup> prior to transferring the case to a district where venue was proper, in part because the statute does not dictate when a transfer should take place. *Id.*, at \*11.

In *Houghton Mifflin*, the jointly administered Chapter 11 cases of Houghton Mifflin Publishing Company and twenty four of its affiliates ("Debtors") were filed in the Southern District of New York with a prepackaged plan of reorganization that received the unanimous support of their creditors. *Id.* at \*1. The United States Trustee ("UST") moved to transfer these cases pursuant to 28 U.S.C. § 1406, shortly before a confirmation hearing on the plan was scheduled, arguing that venue was not proper under 28 U.S.C. § 1408.

*Id.*<sup>132</sup>

Prior to any substantive legal discussion, the court first highlighted the unusual nature of the UST's motion. *Id.* The court recognized that even though the UST may, under appropriate circumstances, properly bring a motion to change venue, both the UST

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<sup>131</sup> A prepackaged plan of reorganization refers to one in which the all of the interested parties have accepted a Chapter 11 plan before the petition for relief is filed. *In re Houghton Mifflin Harcourt Pub. Co.*, --- B.R. ---, 2012 WL 2368547 at \*2, n.5 (Bankr. S.D.N.Y. June 22, 2012).

<sup>132</sup> The UST did request to file its motion on shortened notice, which was denied. *Id.* at \*5.

and creditors may waive venue deficiencies as a matter of “prosecutorial discretion.” *Id.* The court emphasized that venue objections should be raised when prejudice to creditors exists; however, the court intimated that when it is clear that the choice of venue is precisely what creditors desire and a change of venue would result in considerable expense and prejudice thereto, as was the case here,<sup>133</sup> venue objections should be avoided. *See id.* The court then proceeded to discuss the merits of the UST’s motion. *Id.* at \*2.

The court began its analysis by looking to the text of 28 U.S.C. §§ 1406 and 1408. *See id.* Section 1408 provides that a bankruptcy case, “may be commenced in the district in which the domicile, residence, principal place of business...or principal assets... of the person or entity” subject to the case has been located, or in the district where an affiliate’s bankruptcy is pending. *Id.* at \*6, quoting 28 U.S.C. § 1408. Moreover, § 1406<sup>134</sup> states in pertinent part that, “the district court of a district in which is filed a case laying venue in the wrong division or district shall dismiss, or if it be in the interest of justice, transfer such case to any district or division in which it could have been brought.” *Id.* at \*7, quoting 28 U.S.C. § 1406(a). Based on the foregoing, the court reasoned that § 1406’s requirements are mandatory; that is, if the statutory requirements for venue have not been satisfied and a timely objection to venue has been made by a party with standing, the court must either transfer or dismiss the case. *Id.* at \*7. Therefore the court first looked to whether one of the five bases for venue had been satisfied. *See id.* at \*8.

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<sup>133</sup> Since a prepackaged plan was before the court, the case would have been administered in approximately thirty days if the United States Trustee had not moved to transfer the cases. *Id.* Furthermore, the UST’s motion was opposed by virtually every party in the case. *Id.*

<sup>134</sup> Section 1406 has been held to apply to transfers of bankruptcy cases even though it does not specifically mention bankruptcy. *Id.* at \*7-8.

After considering the prospective bases for venue, the court determined that none had been satisfied.<sup>135</sup> *See id.* at \*8-10. Accordingly, the court reasoned that because the “[c]ourt’s hands” were tied by statute and case law, it was required by § 1406 to transfer the case to a district where the case could have been brought. *Id.* at \*10; 28 U.S.C. § 1406. However, the court noted, absent from both statute and case law is when courts must effect a transfer where warranted under § 1406. *Id.* at \*10. Therefore, the court determined that it could implement the Debtors’ prepackaged plan under a timetable that minimizes prejudice to creditors. *Id.* Accordingly, the court chose to effectuate transfer on the effective date of the plan or after entry of the order confirming the plan.<sup>136</sup> *Id.* In light of the foregoing, the court held that venue was improper and took the matter of where to transfer the case on submission.<sup>137</sup>

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<sup>135</sup> Debtors primarily argued that two key debtors, Houghton Mifflin Harcourt Publishing Company (“Publishing”) and Houghton Mifflin Holding Company (“HoldCo”) had established venue under the basis of “residence” and “principal assets,” respectively. *Id.* at \*8-10. The court concluded that “residence” under § 1408 only applied to natural persons, and as such Publishing had not established a proper basis for venue. *Id.* at \*9. The court also found that HoldCo’s “principal assets” did not include a Sixth Avenue lease and sublease and thus HoldCo also had failed to establish a proper basis for venue. *Id.* at \*9-10.

<sup>136</sup> This begs the question of what is left for the transferee court to adjudicate.

<sup>137</sup> In a further attempt to mitigate the resulting prejudice, the court permitted the parties to submit letters explaining their preferences for venue and bases therefor. *Id.* at \*11. Thereafter the court would decide on where to transfer the cases. *Id.* Ultimately, the court transferred the case to Boston, Massachusetts. Bill Rochelle, *Houghton Mifflin Chapter 11 Sent to Boston: Bankruptcy*, BLOOMBERG, (June 29, 2012, 9:00 AM), <http://www.bloomberg.com/news/2012-06-29/houghton-mifflin-chapter-11-sent-to-boston-bankruptcy.html>.



## **Bad Boy Guaranties Are Here for an Extended Stay**

*Bank of America, N.A. v. Lightstone Holdings, LLC*,  
2011 WL 4357491, (N.Y. Sup. Ct. N.Y. County July 14, 2011).

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New York State commercial law has an outsized effect on commercial lending, with nearly one-half of all public company commercial contracts specifying New York as the choice of law.<sup>138</sup> A recent decision the New York State Supreme Court should remind those involved in commercial transactions that so-called “bad boy guaranties”, whereby the principal of a borrower becomes personally liable if the borrower filed bankruptcy, are enforceable under New York law, and should be carefully considered in any commercial financing agreement. *Bank of America, N.A. v. Lightstone Holdings, LLC*, 2011 WL 4357491, (N.Y. Sup. Ct. N.Y. County July 14, 2011) (“*Lightstone*”). *Lightstone* arose out of the bankruptcy of Extended Stay, the largest chain of mid-priced extended stay hotels in the United States, which was the subject of a 2007 leveraged buyout by David Lichtenstein and his investment company, Lightstone Holdings, LLC (the “Lightstone Defendants”). *In re Extended Stay, Inc.*, 418 B.R. 49, 53-54 (Bankr. S.D.N.Y. 2009). Saddled with more than \$7 billion in debt, Extended Stay filed Chapter 11 on June 15, 2009. *Lightstone*, 2011 WL 4357491, at \*2. According to the Debtor’s prepetition secured lenders, the Chapter 11 filing triggered a Guaranty Agreement signed by Lichtenstein obligating him personally and Lightstone Holdings to pay the creditors \$100 million plus prepetition judgment interest (the “Guaranty Agreement”). *Id.*

The Bankruptcy Court handling Extended Stay’s Chapter 11 petition remanded the guaranty suit to New York state court. *Extended Stay*, 418 B.R. at 60-61. In state court,

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<sup>138</sup> Theodore Eisenberg & Geoffrey P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies’ Contracts*, 30 CARDOZO L. REV. 1475, 1478 (2009) (“46 percent of the contracts specify New York as the choice of law,” three times more than any other state).

the Lightstone Defendants raised seven challenges to enforceability of the Guaranty Agreement. *Lightstone*, 2011 WL 4357491, at \*2. The New York court denied the Lightstone Defendants' procedural challenges, noting in particular that this type of bad boy guaranty is an instrument for the payment of money only, meaning the court could rule summarily under New York procedural law. *Id.* at 2-4, citing N.Y. C.P.L.R. § 3213 (McKinney 2011). The New York court also found that the Lightstone Defendants were obligated to pay \$100 million under the language of the Guaranty Agreement. *Id.* at 4-5.

More importantly, the court rejected the Lightstone Defendants' argument that a bad boy guaranty is void as a matter of public policy and as an unenforceable penalty, finding that "defendants waived their rights to assert such a defense" by signing the Guaranty Agreement, which included a an express waiver of a public policy objection, and also because New York public policy did not authorize the defendants to "walk away from their contractual obligations." *Id.* at 5.<sup>139</sup> As a result, the court granted creditors summary judgment against the Lightstone Defendants. This decision serves to remind potential guarantors of commercial financing agreements that their obligations may be enforced under New York law despite the borrower's need to file for bankruptcy protection.

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<sup>139</sup> See *UBS Commercial Mortg. Trust 2007-FL1 v Garrison Special Opportunities Fund L.P.*, 33 Misc.3d 1204(A), 938 N.Y.S.2d 230, 2011 WL 900949 (N.Y. Sup. Ct. N.Y. County Mar. 8, 2011); *Onshore LLC v Sapir*, 2010 WL 5071785 (N.Y. Sup. Ct. N.Y. County Nov. 2010); see also *In re South Side House, LLC*, 470 B.R. 659, 676 (Bankr. E.D.N.Y. 2012) (discussing New York public policy supporting enforceability of guaranties); *Extended Stay*, 418 B.R. at 59. The *Lightstone* court did not address, and apparently the parties did not raise, the issue of whether the Guaranty Agreement might violate public policy by limiting a debtor's ability to file bankruptcy because of the impact that liability may have on the decision making of insider-guarantors as to whether to file or not.