Bankruptcy Circuit Update

Featuring Cases from August 2019

We will be convening our next section-wide conference call on
Friday, October 25, 2019 at 3:30 EST/12:30pm PST
to present and discuss notable cases from the past few months of the summaries.
We are seeking volunteers to summarize significant or interesting cases. Please send an email to *csullivan@diamondmccarthy.com* *if you are interested in presenting a case.*
The call-in information is: ***Dial-In: 866-690-2070 / Code 787-594-2077.***
We hope you will join us for this call.

Fifth Circuit

***Double Eagle Energy Services, L.L.C. v. MarkWest Utica EMG, L.L.C.*, 2019 WL 4010687 (5th Cir. Aug. 26, 2019).**

In this case, the Fifth Circuit reversed the district court's decision to dismiss a breach of contract case brought in Louisiana federal court by a chapter 11 debtor who later assigned its claims to one of its creditors on the basis that the assignment had destroyed the district court's subject matter jurisdiction and personal jurisdiction over the defendants. This opinion deals with the time of filing rule – that subject matter jurisdiction is determined when a federal court's jurisdiction is first invoked and what happens if a lawsuit, when filed, is related to bankruptcy, but then something happens that dissolves the bankruptcy connection.

The chapter 11 debtor Double Eagle Energy Services sued MarkWest and Ohio Gathering on a contract claim in Louisiana federal court. Because the debtor's contract suit was a "civil proceeding[ ] ... related to" a bankruptcy, the district court had subject matter jurisdiction. 28 U.S.C. § 1334(b). But then, the debtor assigned its claim to one of its creditors. The defendants then moved to dismiss the claim on the grounds that the assignment destroyed subject matter jurisdiction under § 1334(b), and that meant the Louisiana federal court lacked personal jurisdiction over the defendants. The magistrate court and the district court agreed.

The Fifth Circuit however came out the other way and held that the district court had erred by failing to apply the time of filing rule to § 1334(b). "It has long been the case that 'the jurisdiction of the court depends upon the state of things at the time of the action brought.'" The Circuit explained that although the time of filing rule is not often considered for cases related to bankruptcy, it applies to bankruptcy jurisdictions no less than it applies to diversity or federal question jurisdictions. Even the closing of a bankruptcy case does not divest federal courts of § 1334(b) jurisdiction over cases that, when filed, were related to bankruptcy. This means that the related to bankruptcy jurisdiction that existed at the outset of the case never went away.

Furthermore, because the district court failed to focus on the time of filing rule, it also erred in its personal jurisdiction analysis. Personal jurisdiction requires – authorization for service of summons and a constitutionally sufficient relationship (the minimum contacts test) between the defendant and the forum. Because the suit remained one under bankruptcy court's § 1334(b) jurisdiction, it meant that the debtor could serve the summons under Bankruptcy Rule 7004. Unlike Rule 4, Bankruptcy Rule 7004 permits nationwide service of process without limitation to the reach of the forum state's courts. With nationwide service, the forum is the United States. So minimum contacts with the United States (Fifth Amendment due process) suffice; minimum contacts with a particular state (Fourteenth Amendment due process) are beside the point. Defendants were residents of the United States and thus they had enough contact with the United States that "haling them into federal court '[did] not offend the traditional notions of fair play and substantial justice." The § 1334(b) jurisdiction that existed when this case was filed thus meant there was both subject matter and personal jurisdiction.

Defendants also contended that the district court should exercise its discretion to dismiss the case. The Circuit remanded the matter back to the district court for it to make that determination because the Circuit's ordinary practice for discretionary decisions is remanding to "allow the district court to exercise its discretion in the first instance."

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Seventh Circuit

In re Sterling, 933 F.3d 828 (7th Cir. 2019).

In *In re Sterling*, the Seventh Circuit affirmed in part and reversed in part the district court's affirmance of the bankruptcy court's order denying the debtor's petition to hold defendants in civil contempt under 11 U.S.C. § 524 for violating the bankruptcy court's discharge order.

Debtor Jacqueline Sterling ("Sterling") owed outstanding fees to Southlake Nautilus Health & Racquet Club, Inc. ("Southlake"). In 2001, Southlake's counsel, Austgen, Kuiper & Associates, P.C. ("Austgen"), filed a claim in Lake County Superior Court. The state court entered a default judgment against Sterling and in favor of Southlake. After several years, during which Sterling failed to appear at several hearings, the state court in April 2010 issued a bench warrant for Sterling. Unbeknownst to the state court at the time, Sterling had filed for bankruptcy, properly included Southlake as a creditor, and received discharge from the bankruptcy court three months prior to the issuance of the bench warrant. In 2011, Sterling was arrested and spent two days in jail, after a police officer discovered the outstanding warrant.

After an unsuccessful state-court lawsuit regarding her arrest, Sterling filed a complaint in bankruptcy court against Southlake, Austgen, and David Austgen, the head of the Austgen firm for violating 11 U.S.C. § 524 by seeking to collect on a discharged debt and petitioned for defendants to be held in civil contempt. To hold the defendants in contempt for violating 11 U.S.C. § 524, the bankruptcy court noted that Sterling had to show that defendants "had knowledge of the granting of her discharge. . . and, despite that knowledge, undertook actions which willfully violated the post-discharge injunction. The bankruptcy court ruled in favor of Austgen and though Southlake had knowledge of the discharge, the court did not find evidence that Southlake directed Austgen to take any further action in the case. The district court affirmed the judgment and Sterling appealed.

A debtor can only ask that a court hold a party in contempt when it violates a bankruptcy order by pursing a discharged debt but only for willful violations. Under *In re Radcliffe*, 563 F.3d 627, 631 (7th Cir. 2009), a showing that the offending party (1) violated the court's order and (2) had actual knowledge that a bankruptcy is under way or has ended in a discharge is required. The panel found that Southlake was liable for the actions taken by the Austgen through the lens of agency law under both federal common law and Indiana law. Clients are principals, the attorney is an agent, and under the law of agency, the principal is bound by the chosen agent's deeds. Southlake countered that it could not be held liable for Austgen's conduct because Austgen did not have the requisite knowledge to be held in contempt. The panel found this argument unpersuasive as agency law also operates to impute an agent's conduct to a principal, even if that conduct did not alone, constitute a tort. The Seventh Circuit affirmed the lower court's rulings regarding Austgen as it did not have firsthand knowledge of the discharge order nor would the court impute Southlake's knowledge to it.

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Eighth Circuit

Ad Hoc Comm. of Non-Consenting Creditors v. Peabody Energy Corp., et al. (In re Peabody Energy Corp.), **933 F.3d 918 (8th Cir. 2019).**

The Eighth Circuit, addressing an issue of first impression in this circuit, held that a chapter 11 plan may provide creditors with an opportunity to participate in offerings of the Debtors' securities at significant discounts without violating the statutory requirement that similarly situated creditors receive equal treatment when, among other things:

1. All creditors have an opportunity to participate in the securities offering

2. the participating creditors provide new commitments in exchange for the opportunity to participate in the securities offering; and
3. the debtor(s) consider several alternatives before determining that the securities offering is the best option to raise capital and provide a recovery to creditors.

The Eighth Circuit also rejected an argument that the Debtors proposed the plan in bad faith. Under the totality of the circumstances, the Eighth Circuit held that the proposed plan resolved various disputes with secured and senior unsecured creditors that otherwise may have prevented the Debtors from reorganizing at all and avoided the substantial costs of delay.

The Debtors, a coal company and its subsidiaries, filed voluntary petitions under chapter 11 and then commenced an adversary proceeding seeking a declaratory judgment to resolve a dispute among seven junior-secured and senior-unsecured creditors (the "Noteholder Co-Proponents" of the plan) about the scope of security interests in coal mines. During non-binding mediation, the parties went beyond the security-interest dispute and negotiated a plan of reorganization.

The plan involved raising $1.5 billion of new money through discounted sales of common and preferred stock. All creditors had an opportunity to participate in a "Rights Offering" that allowed them to purchase common stock at a 45 percent discount to the value that the parties believed the stock to have. In addition, creditors had an opportunity to purchase preferred stock at a 35 percent discount if they became "qualified" by agreeing to: (1) buy a certain amount of preferred stock; (2) backstop both sales by committing to buy any unsubscribed shares; and (3) support the plan in the confirmation process.

The Rights Offering took place in three stages. In stage one, the Noteholder Co-Proponents had the exclusive right to purchase the first 22.5 percent of preferred stock if they agreed to the three conditions and committed to buy whatever remained unsold after the next two stages. In stage two, the Noteholder Co-Proponents and any creditor who became qualified during a three-day window had the exclusive right to purchase the next 5 percent of preferred stock if they agreed to the three conditions. In stage three, the Noteholder Co-Proponents and any creditor who became qualified during a thirty-three-day window could purchase the remaining preferred stock. In addition to the discounts, the qualified creditors received an aggregate $60 million premium for agreeing to backstop the sales and an additional $18,750,000 premium for committing to purchase set amounts of the stock. Finally, the plan provided that the junior-secured creditors would receive an estimated 52.4 percent distribution and the senior unsecured creditors would receive an estimated 22.1 percent distribution on their claims.

A small Ad Hoc Committee of Nonconsenting Creditors chose not to participate in the securities offerings. Instead, they submitted alternative plan proposals, including one by which they offered to backstop a $1.77 billion rights offering that would replace the Debtors' proposal. The Debtors' CFO testified that the Debtors reviewed each proposal and determined that the Ad Hoc Committee's proposals would either not achieve the Debtors' reorganization goals or would add significant expense and delay to the process, estimating the cost at $30 million per month of delay. The Official Committee of Unsecured Creditors independently reviewed the Ad Hoc Committee's proposals and found them to be inferior to the Debtors' proposed plan.

By the time of the confirmation hearing, all twenty classes of creditors voted to approve the plan and approximately 95 percent of unsecured creditors committed to participate in the securities offerings. The bankruptcy court confirmed the plan, holding that the opportunity to participate in the Rights Offering was not treatment for a claim but rather consideration for valuable new commitments. The Ad Hoc Committee promptly appealed to the District court. Following confirmation, the reorganized Debtors began consummating the plan by, among other things, completing the securities offerings, receiving exit financing, and distributing more than $3.5 billion to holders of claims under the plan. The District court held that the appeal was "equitably moot" because the plan had been substantially consummated and, in the alternative, found that the equal-treatment requirement of § 1123(a)(4) had been satisfied and that the plan had been proposed in good faith. The Ad Hoc Committee again promptly appealed.

After noting that other circuits have allowed more favorable treatment to certain claim holders so long as the more favorable treatment is for a new contribution unrelated to the claim, the Eighth Circuit rejected the Ad Hoc Committee's argument that the plan was contrary to Bank of America Nat'l Trust & Savings Ass'n v. 203 North LaSalle Street P'ship, 526 U.S. 434 (1999). In that case, the Supreme Court held that an exclusive right for old equity to purchase shares in the reorganized debtor violated the absolute priority rule. The Eighth Circuit held that this plan was different because: (1) all creditors, including the members of the Ad Hoc Committee, could participate in the securities offerings; (2) in exchange for the right to purchase the securities, creditors gave something of value by committing to support the plan and backstop the sales; and (3) several alternative proposals were considered. Because the right to participate in the securities offerings was consideration for valuable new commitments, it was not "treatment for" a claim and did not violate the equal-treatment rule of § 1123(a)(4).

The Eighth Circuit also rejected the Ad Hoc Committee's arguments that the plan was not proposed in good faith because: (1) the stock was sold at a discount; (2) the Noteholder Co-Proponents had a disproportionate opportunity to purchase stock; and (3) the plan employed a coercive process to induce support. The Eighth Circuit found that the plan was proposed in good faith under the totality of the circumstances because all creditors had notice of and an opportunity to join the negotiations that led to the Debtors' plan and, even though the stock was sold at a discount, the plan allowed the debtors to avoid the substantial cost of an extended stay in bankruptcy and resolve a dispute that could have cost significant time and legal fees, provided for significant distributions to creditors, and was supported by approximately 95 percent of creditors. Although the Noteholder Co-Proponents had a disproportionate opportunity to participate in the Rights Offering, they also took on more obligations and risk by committing to backstop the sales. While the Eighth Circuit expressed concern about the coercive nature of the plan support agreements, it found no clear error in the bankruptcy court's finding of good faith, especially given the need to resolve the case quickly due to the volatile nature of the coal market and the significant costs of a protracted bankruptcy case.

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<u>Ninth Circuit</u>

***In re Dobos*, 603 B.R. 31 (B.A.P. 9th Cir. 2019).**

In *In re Dobos*, the 9th Circuit BAP affirmed the bankruptcy court's order dismissing a nondischargeability complaint.

The plaintiffs had recorded a state court judgment in 2007 which created a lien against Debtor's real property. Debtor filed a Chapter 7 in 2013 and filed a motion to avoid the lien under §522(f). The motion was unopposed and granted. In 2015, plaintiffs moved to reopen the case but took no further action until 2018 when they set the motion for hearing and filed an adversary complaint under §§523(a)(2), (3)(B), and (6). Plaintiffs asserted that they did not have notice of the motion to avoid the judgment lien or the order avoiding the lien.

Debtor moved to dismiss the adversary on the basis that (1) notice was proper; (2) the adversary proceeding was untimely filed; and (3) the judgment was no longer enforceable under state law because it expired 10 years after entry. The bankruptcy court concluded that notice was proper and granted the motion to dismiss

The BAP affirmed on the separate basis that the judgment had expired under state law and a valid claim is a precondition to any action under §523. The BAP stated that §108(c) extends the time to renew a judgment only to the later of the period under state law or 30 days after expiration of the stay, which occurred upon discharge. It does not operate to indefinitely extend the statute of limitations once a Debtor files a bankruptcy. Since the plaintiffs failed to renew their judgment before it expired in 2017, their judgment was not enforceable under state law at the time the filed their adversary complaint.

***In re Juarez*, 603 B.R. 610 (B.A.P. 9th Cir. 2019).**

In *In re Juarez*, the 9th Circuit BAP affirmed the bankruptcy court's order confirming the individual Debtor's Chapter 11 plan.

Unsecured creditors rejected the plan and two unsecured creditors objected to confirmation on several bases including that Debtor did not satisfy the absolute priority rule because the proposed new value contribution was not reasonably equivalent to the value of the property retained. The bankruptcy court overruled the objections and confirmed the plan.

The BAP affirmed and published its decision to address a question of first impression in the circuit: whether the new value contribution must be at least equal to the value of not just the nonexempt assets, but also of the exempt assets.

The BAP held that "exempt property is not properly included within the phrase 'any property' under the absolute priority rule." The BAP explained that the debtor does not retain exempt property "under the plan" or "on account of the debtor's interest" but instead retains exempt property due to the exemption statutes. The BAP further reasoned that exempt property is not liable for prepetition claims or administrative expenses under §522(c) and (k) and requiring a debtor to pay for exempt assets via a new value contribution would effectively make those assets available to creditors.

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<u>Tenth Circuit</u>

***Kitts v. Cashco, Inc., et al. (In re Cashco, Inc.)*, 2019 WL 4307544 (Bankr. D. N.M. July 31, 2019).**

In *Kitts v. Cashco, Inc., et al. (In re Cashco, Inc.)*, Adv. Pro. No. 18-1055-j, 2019 WL 4307544 (Bankr. D. N.M. July 31, 2019), the bankruptcy court denied a request for mandatory abstention of a certified class action complaint that had been filed in state court but granted an alternative request for permissive abstention. The class action centered on allegations of unconscionable loans provided an a 521% APR. The action was stayed by bankruptcy filings by Cashco and 1 other debtor-defendant, Budget Pay Day Loans. Those defendant-debtors, and a non-debtor defendant opposed the abstention motion. The court first found that the claims were "core" claims under 28 U.S.C. § 157(b)(2)(B) (allowance or disallowance of claims). Accordingly, the court concluded that mandatory abstention under 28 U.S.C. § 1334(c)(2) did not apply. But, after analyzing the relevant factors set forth in prior caselaw, citing <u>In re Commercial Fin. Svcs., Inc.</u>, 251 B.R. 414, 429 (Bankr. N.D. Okla. 2000), the court exercised its discretion and granted permissive abstention under § 1334(c)(1). Finally, the court rejected argument that remand of the removed class action to state court (before which the matter was pending prior to removal) was not appropriate because it would waste judicial resources, explaining that remand was appropriate given its permissive abstention ruling.

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<u>Eleventh Circuit</u>

***In re Roth,* 2019 WL 4047509, (11th Cir. Aug. 28, 2019).**

Debtor reopened her Chapter 13 case and filed motion seeking sanctions against mortgage holder for its allegedly willful violation of discharge injunction when it sent an Informational Statement to the debtor. The bankruptcy court denied the motion and the district court affirmed.

In affirming, the Court noted the recent Supreme Court clarification in *Taggart*--"a court may hold a creditor in civil contempt for violating a discharge order if there is *no fair ground of doubt* as to whether the order barred the creditor's conduct." *Taggart v. Lorenzen,* ––– U.S. ––––, 139 S. Ct. 1795, 1801, 204 L.Ed.2d 129 (2019).

In this case, the Chapter 13 plan provided that "[s]ecured creditors, whether or not dealt with under the Plan, shall retain the liens securing such claims." In addition, the discharge order provided that "a creditor may have the right to enforce a valid lien, such as a mortgage or security interest, against the debtor's property after the bankruptcy, if that lien was not avoided or eliminated in the bankruptcy case… a debtor may voluntarily pay any debt that has been discharged." Thus, based on the plan and discharge order, the debtor failed to meet her burden since the Informational Statement clearly stated that it was "for informational purposes only and is not intended as an attempt to collect, assess, or recover a discharged debt from you, or as a demand for payment from any individual protected by the United States Bankruptcy Code," and "is not an attempt to collect a debt." Further, the Informational Statement included a payment coupon marked in large lettering as "voluntary." The Informational Statement was merely giving the debtor the option to make a payment before the bank foreclosed on its mortgage.

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