

Bankruptcy Circuit Update

Featuring Cases from July 2019

*We will be convening our next section-wide conference call on **Friday, August 23, 2019 at 3:30 EST/12:30 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.*

Second Circuit

Jones v. Brand Law Firm (In re Belmonte), 18-2098 (2nd Cir., July 25, 2019)

The Second Circuit affirmed the judgment of the district court affirming the bankruptcy court's order requiring the Brand Law Firm ("Brand") to remit approximately \$60,000 to the trustee of the bankruptcy estate of Alice Belmonte ("Belmonte"), holding that where avoidance of a mortgage does not result in the avoided lien becoming available for liquidation and distribution to creditors, Bankruptcy Code section 550(d)'s single satisfaction rule does not bar a chapter 7 trustee from seeking recovery from other sources.

Belmonte hired Brand to represent her in connection with an involuntary petition that had been filed against her. After the resulting chapter 7 case commenced, Belmonte was arrested pursuant to a 49-count indictment filed in state court, which alleged that Belmonte had engaged in a scheme to defraud certain creditors of her estate. Belmonte hired Brand and two other attorneys to represent her in the criminal proceedings.

In order to fund her defense in the criminal case, a personal friend of Belmonte agreed to lend her \$250,000 (the "Loan"). The Loan was secured by a second mortgage on property of her bankruptcy estate. At the time the second mortgage was executed, both Belmonte and her friend knew of the pending bankruptcy case. Per an agreement between Brand and Belmonte's other two criminal defense attorneys, Brand transferred \$73,147 and \$54,490 to the other two lawyers as payment for their legal services and retained \$118,864 of the Loan.

Harold D. Jones, the trustee of Belmonte's estate (the "Trustee"), filed an adversary proceeding to have the mortgage and the transfer of the \$250,000 loan avoided as illegal post-petition transfers of the estate's property under Bankruptcy Code section 549. The bankruptcy court ultimately approved a settlement between the Trustee and the party who made the loan and the mortgage was avoided, while the lien created by the mortgage was preserved for the benefit of Belmonte's estate pursuant to Bankruptcy Code section 551.

The Trustee later filed a complaint in the bankruptcy court against Brand, seeking to avoid the transfer of the Loan proceeds to Brand. The Trustee alleged that the money that

Belmonte obtained from the Loan was property of the estate, because the Loan was secured by the property subject to the mortgage and Bankruptcy Code section 541(a)(6) makes the “[p]roceeds, product, offspring, rents, or profits of or from property of the estate” also property of the estate. Because the transfer took place when Belmonte was not authorized to transfer estate property, the Trustee argued that the transfer of the Loan to Brand was avoidable pursuant to Bankruptcy Code section 549 and sought to recover the proceeds from Brand pursuant to Bankruptcy Code section 550(a).

In the answer to the complaint, Brand alleged that the Trustee’s claim was barred by the election of remedies doctrine and the prohibition on double recovery set forth in Bankruptcy Code section 550(d), as a result of the Trustee’s settlement avoiding the mortgage and preserving the lien created by the mortgage for the benefit of the estate. The bankruptcy court rejected this argument, reasoning that litigants may look to multiple parties to recover the same loss until they are ultimately paid, and that here the Trustee had not yet recovered any of the \$250,000 allegedly borrowed by Belmonte and transferred to Brand.

Accordingly, the bankruptcy court avoided the two post-petition transfers and also ordered Brand to remit \$59,432 of the proceeds of the loan to the Trustee, with such amount representing half of the \$118,864 from the Loan that Brand retained after it paid Belmonte’s other criminal defense attorneys. On appeal, the district court affirmed the bankruptcy court’s order and also rejected Brand’s argument that the Trustee’s recovery of the \$59,432 from Brand constituted a double recovery for the estate. The district court concluded that Brand conflated two separate transactions: (i) the transfer of the mortgage to the party who made the Loan to Belmonte; and (ii) the transfer of the \$250,000 Loan to Brand. The district court explained that the avoidance of the mortgage simply allowed Belmonte’s estate to assume the lien rights to the underlying property that had been improperly transferred to the party who made the loan and that such assumption did not bar the Trustee from seeking to recover the loan proceeds that Belmonte had transferred to Brand.

On appeal in the Second Circuit, Brand repeated its argument that the Trustee’s recovery of the Loan under section 550(a) constituted a double recovery for Belmonte’s estate in violation of section 550(d), arguing that, through the Trustee’s settlement avoiding the mortgage, the Trustee had already recovered Belmonte’s equity interest in the underlying property. Accordingly, Brand asserted that the bankruptcy court and the district court erred in concluding that the Loan was an additional recoverable asset of the Belmonte’s estate.

The Second Circuit disagreed, and concluded that the Trustee’s recovery of a portion of the Loan from Brand did not violate the single satisfaction rule of section 550(d). The Second Circuit initially noted that section 550(d) most commonly applies in cases where section 550(a) enables a trustee to recover the value of transferred property from more than one transferee, possibly allowing the trustee to recover more than the value of the avoided transfer. Here, however, Brand made a different 550(d) argument, alleging that when the Trustee successfully avoided the mortgage, Belmonte’s estate was restored to the position it was in before the avoided transfers, and that, as a result, recovering any amount of the Loan proceeds from Brand would constitute a double recovery for Belmonte’s estate.

The Second Circuit was not persuaded by this reasoning, noting that Brand misapprehended the nature of bankruptcy law, the language of section 550(d), and the economic realities of this case. Here, when the Trustee sought to recover the Loan from Brand, the Trustee had not realized any part of the value of Belmonte's equity interest in the underlying property. Instead, the Trustee's settlement gave the Trustee the rights of a lien creditor with respect to the underlying property. The Second Circuit noted that a mortgage carries only a right to foreclose on a debtor's property in the event of default, and in this case, the bankruptcy court had previously prohibited the Trustee from forcing a sale of the underlying property. Because the Trustee was unable to liquidate the estate's equity in the underlying property, preservation of the lien did not create any realized value for Belmonte's creditors. Further, the Trustee's settlement did not provide for any payment to the Belmonte's estate, let alone payment of the roughly \$130,000 equity value of Belmonte's interest in the underlying property. Thus, while the lien on the property was preserved for the benefit of the estate, the Trustee's only route to realize any recovery for the estate from the unlawful transfer of estate property by Belmonte was by seeking the proceeds of the Loan.

The Second Circuit noted that section 550(a) authorizes a trustee to pursue recovery from all available sources until the full amount of unlawfully transferred estate property is fully realized for the estate's creditors. Here, by recovering a portion of the Loan proceeds from Brand, the Second Circuit reasoned that the Trustee merely expedited the ultimate satisfaction of the claim for the benefit of the creditors. The Second Circuit also found all of the cases that Brand cited to in support of his argument to be distinguishable, because unlike the debtors in those cases, here Belmonte realized \$250,000 in net proceeds by granting the mortgage, remitted none of that money to the estate, and instead transferred the entire proceeds directly to Brand. Belmonte's estate realized none of the equity value of the mortgage for the benefit of the creditors and did not obtain title to real property. In short, the Second Circuit held that where (as here) avoidance does not result in the avoided lien becoming available for liquidation and distribution to creditors, section 550(d)'s single satisfaction rule is no obstacle to recovery by the estate from other sources. Accordingly, the Second Circuit affirmed the judgment of the district court.

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Seventh Circuit

***In re Jaffe*, 2019 WL 3540420, (7th Cir. Aug. 5, 2019)**

In *Jaffe*, the appellant, Laverne Williams (“Williams”), won a default judgment in a malpractice suit against her former attorney, Scott Jaffe (“Jaffe”). Williams recorded the judgment on the Jaffes’ home, which both he and his wife owned as tenants by the entirety. Jaffe acknowledged his debt to Williams in his Chapter 7 bankruptcy petition. Jaffe’s wife later died.

To avoid the judgment lien, Jaffe filed a motion in the bankruptcy court arguing the property was exempt under 11 U.S.C. § 522(b)(3)(B). This section of the Bankruptcy Code exempts property from the bankruptcy estate when the debtor had an interest in the property by tenancy in the entirety prior to the commencement of the case. Williams argued that the property was not exempt because the bankruptcy provision looks to state law to determine whether a tenancy property is exempt and her lien attached to Jaffe’s contingent future interest which is not exempt under Illinois law. Jaffe contended the lien only attached to his tenancy interest which is exempt under Illinois law.

Section 12–101 of the Illinois code creates judgment liens and controls their ability to attach to certain property interests. The statute provides that judgment liens may attach to all “real estate” and defines “real estate” broadly to include all legal and equitable rights therein, including in part: “a survivorship interest in the entire property in the event of the other tenant’s death.” Therefore, the judgment lien attached to Jaffe’s contingent future interest. The district court concluded that any interest Jaffe held, including the contingent future interest, was exempt because the tenancy interest was exempt under Illinois law.

The Seventh Circuit disagreed, finding that the lower court’s reasoning would mean that “no matter how nuanced state exemptions for tenants by the entirety are, all interests would be exempt if the state exempts the entirety interest.” The panel noted that “[t]he main protection that Illinois law provides tenants by the entirety is that a creditor is unable to force the sale of the property to collect a debt against only one of the tenants ... Illinois law does not make all interests held by tenants by the entirety immune from process.” Accordingly, the Seventh Circuit reversed, finding that Jaffe was not entitled to an exemption of his contingent future interest.

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Eighth Circuit

***Edwards v. City of Ferguson (In re Edwards),* 601 B.R. 660 (BAP 8th Cir. 2019)**

The Eighth Circuit Bankruptcy Appellate Panel held that a city does not violate the automatic stay by not taking post-petition actions to rescind an arrest warrant and not issuing a compliance letter to assist in reinstatement of a debtor's driver's license.

The debtor was given a speeding ticket six years prior to filing her voluntary petition under chapter 13. After she failed to show up for the initial court date, an arrest warrant was issued. She then pleaded guilty to speeding, but never paid the fine. Non-payment of the fine eventually resulted in her driver's license not being renewed. About eight months before the petition date, the city re-issued the arrest warrant, but did not take any affirmative action to enforce the warrant or collect the fine. The day after filing the bankruptcy petition, the debtor's attorney notified the city of the filing and requested that the city release the arrest warrant and issue a compliance letter to reinstate the debtor's driver's license. In response, the city's counsel suggested that the debtor file a motion with the Ferguson Municipal court. Instead, the debtor filed a complaint to initiate an adversary proceeding alleging violation of the automatic stay of § 362(a) and unfair discrimination under § 525. The parties filed cross motions for summary judgment. The bankruptcy court granted the city's motion and denied the debtor's motion.

The debtor appealed only the ruling on the automatic stay, arguing that inaction by itself constitutes a violation of the automatic stay. The BAP noted that there are situations where inaction is a violation of the automatic stay, such as failure to stop wage garnishment that was initiated pre-petition. But, the BAP noted that the existence of an outstanding arrest warrant does not mean that the city will try to enforce it.

The BAP also held that nothing in the Bankruptcy Code compels the city to issue a compliance letter, especially when such a letter would be false because the debtor admits that she has not complied with the fine. Furthermore, the BAP noted that the debtor did not provide any evidence that the State of Missouri refused to issue her a driver's license based on the unpaid fine and, furthermore, the State of Missouri was not even a party to the adversary proceeding.

Finally, the debtor argued that the city's attorney's response to the debtor's post-petition request was somehow a violation of the automatic stay. The BAP held that a response to an inquiry is not an attempt to collect a debt and therefore not a violation of the automatic stay.

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Eighth Circuit #2

Abel and Metro Acoustics, LLC v Queen and Queen (In re Queen),
No. 18-6023, 2019 WL 3242035 (BAP 8th Cir. July 19, 2019)

The Eighth Circuit Bankruptcy Appellate Panel affirmed entry of summary judgment in favor of the debtor-defendants and held that it lacked jurisdiction to consider an issue that was raised only in a withdrawn motion.

The debtors' former business partner sued the debtors in state court alleging fraudulent misrepresentation and breach of fiduciary duty, among other claims. After striking the debtors' pleadings, the state court entered default judgment on liability and scheduled a hearing to determine damages. The debtors filed their voluntary petition before the hearing date and the plaintiffs timely filed a complaint seeking exception to discharge under §§ 523(a)(2), (4), and (6).

The plaintiffs filed a motion for partial summary judgment and argued that the state court default judgment precluded the debtor-defendants from re-litigating liability or the issue of dischargeability. After the hearing on this motion, the bankruptcy court stamped a copy of the motion "DENIED" and "WITHDRAWN" and entered it as an order. The parties then agreed that the sole issue to be decided was dischargeability under § 523(a)(4) "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny[.]" The parties also agreed to submit the issue on stipulated exhibits, stipulated facts, and briefs without a trial. The plaintiffs' brief did not argue claim preclusion or even mention the state court judgment.

In the order granting summary judgment in favor of the debtor-defendants, the bankruptcy court included a section titled "PRELIMINARY MATTERS" that said the state court judgment "was only a default judgment" that did not establish any facts for the purposes of summary judgment.

On appeal, the plaintiffs argued that the bankruptcy court erred by not applying issue preclusion. The BAP held that regardless of the bankruptcy court's passing reference to the state court default judgment, issue preclusion was no longer before the bankruptcy court because the record showed that the issue had been withdrawn and was not reasserted when the parties submitted the case on stipulated facts and briefing. Because issue preclusion was abandoned, the BAP held it "afford[ed] no basis for the instant appeal." Therefore, the BAP affirmed summary judgment in favor of the debtors.

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Eighth Circuit #3

Fulmer v. Fifth Third Equip. Fin. Co. et al. (In re Veg Liquidation, Inc.),
No. 18-1786 (8th Cir. Jul. 26, 2019),

The Eighth Circuit affirmed the dismissal of an adversary proceeding (“AP”) on the basis that it was an impermissible collateral attack on a prior 363 sale order and the denial of the trustee’s motion to amend the complaint on the basis of futility.

Two years after the bankruptcy court approved the sale of the debtor’s assets and converted the case from chapter 11 to 7, the trustee commenced an AP against parties including the purchaser of the debtor’s assets and creditors who allegedly supported the purchaser’s bid in exchange for an agreement not to pursue preference claims that were included among the sale assets. The trustee claimed that the 363 sale was a sham and a fraud on the court and that the parties had conspired to manipulate the value of assets in the sale. The bankruptcy court dismissed the trustee’s claims as either impermissible collateral attacks on a sale order or without merit. The trustee appealed and the BAP affirmed.

Before the Eighth Circuit, the trustee again argued, among other things, that *res judicata* should not apply because most of the defendants were not parties to the sale order and that the AP was not a collateral attack on the sale because of a lack of privity and because the trustee’s claims were not “integral” to the sale. Reviewing de novo, the Eighth Circuit rejected the trustee’s argument that *res judicata* should not apply because a § 363 sale is an *in rem* proceeding that transfers property rights “good against the world, not just against parties to a judgment or persons with notice of the proceeding.” For the same reason, the Eighth Circuit rejected the trustee’s argument that lack of privity meant the AP was not a collateral attack.

Without determining whether a collateral attack is limited to “integral” provisions of a sale order, the Eighth Circuit rejected the proposition that the trustee’s claims were not “integral” because “[u]ndermining the sale order’s finding that [the purchaser’s] consideration was the highest and otherwise best offer for the Acquired Assets would adversely alter the parties’ bargained-for exchange.”

The trustee also argued that the sale order is unenforceable because the required elements for a sale were not adequately proven. The Eighth Circuit rejected this argument as an issue that may be raised only on direct appeal, not through a separate AP.

The trustee also argued that the sale order should be set aside because it was allegedly obtained through fraud on the court. The Eighth Circuit rejected this argument because fraud on the court applies only to “the most egregious misconduct directed to the court itself, such as bribery of a judge or jury or fabrication of evidence by counsel” and the facts alleged did not involve conduct directed to the court.

Finally, the Eighth Circuit rejected the trustee’s argument that the recently-decided Supreme Court case of *Czyzewski v. Jevic Holding Corp.*, ___ U.S. ___, 137 S. Ct. 973 (2017) barred the bankruptcy court from approving a sale that would violate the absolute priority rule because *Jevic* on its face does not apply to anything other than structured dismissals. Furthermore, the Eighth Circuit noted that even if *Jevic* did apply to a sale order, the Supreme

Court in *United Student Aid Funds, Inc. v. Espinosa*, 559 U.S. 260, 273-76 (2010), stated that a final order is not “void” simply because it violates the requirements of the Bankruptcy Code.

Fulmer stands for the proposition that a court ordinarily cannot undo a 363 sale once it becomes final. Objections must be made to the sale; not in an adversary proceeding filed after the time to appeal the sale has passed.

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Ninth Circuit

***Hurley v. United States of America (In re Hurley)*, 601 B.R. 529 (B.A.P. 9th Cir. 2019)**

In *Hurley v. United States of America*, the debtor, Paul Hurley (“Hurley”), filed a chapter 7 bankruptcy case a month after his conviction of two felonious crimes: (1) Receiving a Bribe by a Public Official and (2) Receiving an Illegal Gratuity by a Public Official. While employed as a revenue agent for the Internal Revenue Service, Hurley audited federal tax returns for Have a Heart Compassion Care, Inc. and solicited \$20,000 from its representative on the basis of having purportedly saved the company \$ 1 million in taxes. Concerned that Hurley would not completed the audit statements, Have a Heart Compassion Care, Inc. paid Hurley so that he could pay his student loans. At the time of his bankruptcy, Hurley’s debts consist almost entirely of his \$250,000 student loans. While incarcerated, Hurley filed a complaint against United States of America and Accesslex Institute seeking to discharge his entire student loan debt under section 523(a)(8) of the Bankruptcy Code. Defendants moved for summary judgment arguing that Hurley was unable to satisfy the third prong of the *Brunner* test: that the debtor has made good faith efforts to repay the loans. Hurley countered that one past bad act should be dispositive of good faith under *Brunner*, and the court should instead consider present-tense factors. The bankruptcy court granted the Defendants’ summary motion.

Hurley appealed presenting the following issue before the Ninth Circuit: did the bankruptcy court err in determining that Hurley could not establish good faith under *Brunner*? The Ninth Circuit affirmed the bankruptcy court’s decision to grant summary judgment in the Defendants’ favor given Hurley’s background and the nature of his criminal conduct resulting in lack of good faith and therefore, was not entitled to a hardship discharge of his student loans under section 523(a)(8).

Generally, student loan obligations are presumed to be excepted from a debtor’s discharge under Section 727 of the Bankruptcy Code, unless repaying those loans would impose an undue hardship on the debtor and the debtor’s dependents. The Ninth Circuit has assembled a list of factors in considering a good faith determination: (1) whether the debtor has made any payments on the loan prior to filing for discharge, although a history of making or not making payments is, by itself, not dispositive; (2) whether the debtor has sought deferments or forbearances; (3) the

timing of the debtor's attempt to have the loan discharged; and (4) whether the debtor's financial condition resulted from factors beyond her reasonable control, as a debtor may not willfully or negligently cause her own default. Though most of these factors weigh in favor of Hurley, the Court could not overlook the last factor and specifically that Hurley's "current condition was self-inflicted by his willful, criminal conduct, and this outweighed his earlier good-faith efforts of repayment."

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Eleventh Circuit

In re Yerian, 2019 WL 2610751 (11th Cir. June 26, 2019)

This appeal stems from the bankruptcy court's order denying the debtor's IRA exemption, which the district court affirmed. The Eleventh Circuit affirmed the district court.

Prior to the bankruptcy, the debtor established a self-directed IRA that at the time complied with the IRS Code's requirements for an IRA. However, the debtor later used funds from the IRA to purchase a home and purchase two cars, all for personal use—"self-dealing." On appeal, the debtor argued that the IRA was exempt so long as the form of the governing documents satisfied the requirements of the IRS Code on paper at the time. In affirming, the Court held that the debtor "forfeited his exemption [under state law] when he engaged in self-dealing transactions prohibited by the IRA's governing documents."

Section 222.21 of the Florida Statutes imposes different exemption requirements on different IRAs, depending on whether and how the Internal Revenue Service has signed off on the IRA's terms. At issue here was 222.21(2)(a)(2), which permitted the exemption only if over time, the IRA was "maintained in accordance with" the plan or governing instrument.

In this case there were two contracts that governed the plan—a Traditional IRS Agreement and an IRA LLC Agreement (the "Agreement"). The Agreement contained the following language: "I acknowledge that I have not and will not engage in any prohibited transactions within my retirement account or its asset holdings." The Agreement further stated, "A prohibited transaction is a transaction between a plan (the LLC) and a disqualified person that is prohibited by law." The Agreement explained that a prohibited transaction included any "act of a fiduciary by which plan income or assets are used for his or her own interest," and any "transfer of plan income or assets to, or use of them by or for the benefit of, a disqualified person." A "disqualified person," in turn, explicitly included "the owner" of the IRA as well as the owner's "spouse." Thus, by the debtor's

own admission of self-dealing, with respect to the purchase of the home and two vehicles, failed to maintain his IRA in accordance with its governing instrument—the Agreement.

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