Bankruptcy Circuit Update

Featuring Cases from September 2019

We will be convening our next section-wide conference call on
Friday, October 25, 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

***Murphy v. Snyder* (*In re Snyder*), 939 F.3d 92 (2nd Cir. 2019).**

The Second Circuit vacated in part and affirmed in part a judgment by the district court affirming a bankruptcy court order deeming nondischargeable a prior default judgment entered against Stuart and Doreen Snyder (together, the "Snyders") in favor of Joseph and Nancy Murphy (the "Murphys") in the United States District Court for the Eastern District of New York (the "Eastern District Judgment").

Prior to the events that gave rise to this case, the Snyders and Murphys were close and tied by familial relations, as Doreen Snyder is also Joseph Murphy's sister. Stuart Snyder worked in the custom home building business and partly operated such business through an entity called BBSea Associates, LLC ("BBSea"). Sometime in 2005, Stuart Snyder entered an agreement to build luxury homes in New Jersey (the "New Jersey Project"). The Murphys later entered an oral agreement with the Snyders to become "silent partners" on the New Jersey Project, with the Snyders promising to repay the initial investment and a return of 20%. Pursuant to that agreement, the Murphys wired $100,000 to an attorney trust account. However, the Murphys were never repaid the $100,000 nor did they receive any return on their investment.

In 2006, the Murphys entered into a second oral agreement with the Snyders to invest $275,000 in a luxury home building project in Connecticut (the "Connecticut Project"). The Snyders promised the Murphys a return of their $275,000, plus at least a 20% profit. On August 28, 2006, Joseph Murphy wired $275,000 to a bank account in the name of BBSea, with the understanding that the money would be used to purchase the property needed for the Connecticut Project. Instead, that money was used for other projects and purposes. Again, the Murphys were never repaid the $275,000 nor did they receive any return on their investment.

In 2010, the Murphys sued the Snyders for breach of contract, fraud, and several other causes of action. After the filing of the case, the Snyders refused to adequately comply with discovery requests, prompting the Murphys to move for sanctions and a default judgment. The district court agreed to strike the answer, award sanctions, and enter a default judgment. Shortly afterwards, two new law firms entered appearances on behalf of the Snyders, the first of which

filed a motion to vacate the default judgment. The district court granted the motion to vacate the default, conditioned on the defendants' paying the sanctions award.

In 2013, Snyder's then current counsel moved to withdraw, noting that the Snyders were not paying their legal fees and were refusing to communicate with counsel. The district court granted the motion and informed the Snyders that they had 30 days to find new counsel, and that failure to retain counsel would likely result in entry of a default judgment. Shortly afterwards, the district court entered a scheduling order requiring the Snyders to comply with an expedited discovery schedule. The Murphys served the Snyders with a second set of interrogatories and discovery requests, as well as a "good faith letter" requesting compliance with the scheduling order, but the Snyders did not respond, and also failed to appear for scheduled depositions and a court conference.

Accordingly, the Murphys moved to strike the answer and for a default judgment pursuant to Federal Rule of Civil Procedure 37. In September 2014, the district court entered the default judgment and awarded damages of (1) $120,000 in compensatory damages flowing from the breach of the contract for the New Jersey Project, plus prejudgment interest of $56,515.07; (2) $330,000 in compensatory damages flowing from the breach of the contract for the Connecticut Project, plus $127,913.42 in prejudgment interest; and (3) post-judgment interest and costs of $350.

In April 2015, the Snyders filed for Chapter 11, though the proceedings were later converted to Chapter 7. In July 2015, the Murphys commenced an adversary proceeding, seeking a declaration that the Eastern District Judgment was nondischargeable pursuant to 11 U.S.C. §§ 523(a)(2)(A) (debt nondischargeable when obtained through false pretenses, false representation, or actual fraud); 523(a)(4) (debt nondischargeable when obtained through "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny"); and 523(a)(6) (debt nondischargeable when obtained through "willful and malicious injury by the debtor to another entity or to the property of another entity."). In August 2016, the Murphys moved for summary judgment, which the Snyders opposed. The bankruptcy court granted the motion with respect to the defalcation, embezzlement, and willful and malicious injury claims brought pursuant to Sections 523(a)(4) and (a)(6) but denied the motion with respect to the false pretenses or actual fraud claim brought pursuant to Section 523(a)(2)(A). The Snyders appealed to the district court, which affirmed the bankruptcy court's ruling as to the defalcation and willful and malicious injury claims but declined to address the embezzlement claim. The Snyders then appealed to the Second Circuit.

The Second Circuit began its analysis by addressing issues relating to collateral estoppel, noting that issue preclusion principles apply in bankruptcy proceedings and that collateral estoppel may be used to establish the nondischargeability of a debt. The Second Circuit also noted that, as with state court judgments, a bankruptcy court must give federal court judgments the same preclusive effect other federal courts would.

A party seeking to invoke collateral estoppel must establish that (1) the identical issue was raised in a previous proceeding; (2) the issue was actually litigated and decided in the previous

proceeding; (3) the party had a full and fair opportunity to litigate the issue; and (4) the resolution of the issue was necessary to support a valid and final judgment on the merits. The Second Circuit noted that the requirement that the underlying issue be "actually litigated" generally bars a court from giving a default judgment preclusive effect. However, the Second Circuit noted that it joins several other circuits in recognizing an exception to that rule: where the default judgment is entered as a sanction for bad conduct, and the party being estopped had the opportunity to participate in the underlying litigation, then the default judgment has preclusive effect when determining the nondischargeability of a debt in a bankruptcy proceeding.

The Second Circuit noted that affording a default judgment entered as a sanction preclusive effect furthers the goal of imposing the sanction in the first instance because it deprives the sanctioned party an opportunity to relitigate an issue that could and should have been decided in the first litigation. Here, the record conclusively established that the Snyders repeatedly failed to comply with their discovery obligations in the Eastern District litigation and repeatedly failed to remedy the situation. Accordingly, the Second Circuit held that the Snyders were bound by the facts decided by the Eastern District and necessary to the entry of the Eastern District Judgment, including that (1) the Snyders entered, and breached, agreements with the Murphys regarding the New Jersey and Connecticut Projects; and (2) both Snyders were liable for the resulting damages.

The Second Circuit then turned to the central issues regarding nondischargability. The Second Circuit noted that, pursuant to section 727(b) of the Bankruptcy Code, parties filing for bankruptcy are generally entitled to a discharge "from all debts that arose before the date of the order for relief." However, this "fresh start" is only intended to benefit an "honest" debtor, and pursuant to sections 523(a)(4) and (6) of the Bankruptcy Code, discharge is not permitted when a debt is incurred through "fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny," or through "willful and malicious injury by the debtor to another entity or to the property of another entity."

A threshold determination in this context is whether the debtor acted in a fiduciary capacity, which may be determined by state law. The Second Circuit held that, regardless of whether New York, Connecticut or New Jersey law applied, the Snyders acted as fiduciaries for the Murphys. The undisputed facts established that the Snyders and Murphys were engaged in a joint venture with regard to both the New Jersey and Connecticut Projects, and under the law of all three states, the members of a joint venture undertake fiduciary duties to each other.

However, the Second Circuit noted that a fiduciary relationship alone is not enough for the defalcation exception to apply. Defalcation also requires a culpable state of mind, specifically, knowledge of, or gross recklessness with respect to, the improper nature of the relevant fiduciary behavior. In determining that the Snyders acted with the intent necessary to commit defalcation, the lower courts both found that the Snyders acted with gross recklessness in using monies intended by the Murphys for purchasing the property for the Connecticut Project on personal expenses.

On appeal, the Snyders argued that the lower courts erred by relying only on the Snyders' actions in relation to the Connecticut Project in finding the intent necessary for defalcation with

regard to the New Jersey Project. The Second Circuit agreed with this reasoning, finding that the district court failed to consider whether the debt could be fairly parsed so as to consider the debt associated with the New Jersey Project separately from the debt associated with the Connecticut Project. The Second Circuit explained that the proper inquiry here required the court to examine whether the Snyders committed defalcation with regard to the monies involved in the New Jersey and Connecticut Projects separately, not with regard to the debt as a whole. The Second Circuit noted that, under different factual circumstances, the portions of a contested debt may be so intertwined as to make division infeasible, but that is not the analysis at issue here. The Eastern District Judgment allocated damages for the New Jersey and Connecticut Projects separately, including separate interest awards, making the two debts easily parsed.

The Second Circuit then addressed the two debts separately, noting first that, with regard to the New Jersey Project, the undisputed evidence is that the Murphys wired their funds to an attorney trust account that the Snyders alleged was controlled by the attorney of the Snyders' contract counterparty relating to the New Jersey Project. Stuart Snyder stated that the counterparty told him the funds were used to buy the property for the New Jersey Project, and that Stuart Snyder never received, nor had possession of or controlled this investment. The Murphys provided no evidence to dispute this contention. Accordingly, the Second Circuit held that the Snyders raised a triable issue of fact as to whether a defalcation occurred as to the New Jersey Project.

Conversely, the Second Circuit held that there was ample evidence in the record to support the finding of defalcation with regard to the Connecticut Project. The Murphys wire transferred the funds to a bank account controlled by BBSea with the expectation that they would be used to purchase the property for the Connecticut Project. Instead, that money was used for other projects and purposes without notice to or authorization by the Murphys. Stuart Snyder admitted that he spent some of the investment on personal expenses and that he used his business accounts at that time to pay his personal as well as business expenses. Moreover, the property for the Connecticut Project was never purchased. Accordingly, the Second Circuit held that the damages and interest awarded in the Eastern District Judgment for the breach of contract regarding the Connecticut Project were nondischargeable.

The Second Circuit then briefly addressed section 523(a)(6) of the Bankruptcy Code, which provides that a debt for willful and malicious injury by the debtor to another is not dischargeable.

The Second Circuit noted that its analysis underlying its decision on the defalcation claim applies equally in this context, and accordingly the Second Circuit found that the Snyders raised a triable question of fact as to whether the debt associated with the New Jersey Project was nondischargeable pursuant to Section 523(a)(6). As the Second Circuit affirmed the finding of defalcation with regard to the debt associated with the Connecticut Project, the Second Circuit did not address whether that debt was also nondischargeable pursuant to Section 523(a)(6).

Accordingly, the Second Circuit (i) vacated and remanded the finding of nondischargeability as to the part of the debt associated with the New Jersey Project, and (ii) affirmed the finding of nondischargeability as to the debt associated with the Connecticut Project.

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Fifth Circuit

***Matter of Linn Energy, L.L.C.*, 936 F.3d 334 (5th Cir. 2019).**

In *Matter of: Linn Energy, L.L.C.*, Appellant, a trust beneficiary's estate (hereinafter, "Appellant"), filed claims in the underlying bankruptcy for failure to pay deemed dividends. Appellee (the debtor) objected, requesting the bankruptcy court expunge or subordinate Appellant's claims. The bankruptcy court sustained Appellee's objection, and subordinated some of Appellants' claims. Appellant appealed, first to the district court, which affirmed, and then to the Fifth Circuit. While the appeal was pending before the Fifth Circuit, the bankruptcy court subordinated Appellant's remaining claims. The Fifth Circuit granted direct appeal to consolidate Appellant's appeals.

On appeal, the Fifth Circuit primarily addressed: (1) whether the nature of Appellant's interest make the estate more like an investor or a creditor; (2) whether the Appellant's claims pertain to securities of the debtor; and (3) whether Appellant claims arise from the purchase or sale of a security of the debtor.

In arriving at its decision, the Court reasoned that "[g]iven its ambiguity, the policy rationales behind [11 U.S.C. § 510(b)] must always guide its interpretation and application to particular facts." For the Fifth Circuit, the "most important policy rationale behind Section 510(b) is that claims seeking to recover a portion of [Appellants'] equity investments should be subordinated." Appellee suggested the Court should find subordination under 11 U.S.C. § 510(b) where: (1) a claim is for "damages," (2) the claim involves "securities," and (3) the claim "arise[s] from" a "purchase or sale" having a nexus with those securities. The Fifth Circuit agreed, ultimately deciding "payments owed to a shareholder by a bankrupt debtor, which were not quite dividends but which certainly look a lot like dividends, should be treated like the equity interests of a shareholder and subordinated to claims by creditors of the debtor."

Applying Appellee's framework, the Court determined—and all parties conceded—that the claims for deemed dividends were claims for damages. Appellant argued the damages do not arise from the purchase or sale of a security because "[Appellant] could not sell, bequeath, or otherwise transfer the life interest he obtained in the deemed dividends through his membership." Moreover, Appellant's "interest did not convey any voting or shareholder rights to him, was non-negotiable, and did not give him a right to demand dividend payments." Here, the Fifth Circuit, reasoned the deemed dividends "gave [Appellant] the same risk and benefit expectations as shareholders." Having determined the "deemed dividend interest owned by the Estate is a security interest under the residual clause of the Bankruptcy Code," the Court did not reach the debtor's fallback position.

As a secondary matter, the Fifth Circuit held the bankruptcy court did not abuse its discretion in denying discovery, because the undetermined issues are "legal issues . . . or are irrelevant."

Accordingly, the Court affirmed the decisions of the district court and bankruptcy court.

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Seventh Circuit

In re I80 Equip., LLC, 938 F.3d 866 (7th Cir. 2019).

I80 Equipment ("Debtor") purchased and refurbished trucks for resale. In 2015, Debtor obtained a loan from First Midwest Bank ("Bank") and executed a Security Agreement which granted Bank a security interest in nearly all of Debtor's assets. This included cash, equipment, accounts receivable, instruments, goods, inventory, and proceeds. Bank filed a UCC financing statement with the Illinois Secretary of State to perfect its security interest. The identification of the collateral in the financing statement was only a reference to "all collateral" described in the Security Agreement which was identified by date. The Security Agreement was not attached to the financing statement.

Two years later, Debtor defaulted on the loan and filed a petition under Chapter 7. Bank sued the trustee for $7.6 million on the loan and security agreement, claiming its security interest was senior to all other claimants, including the trustee. The trustee then asserted a counterclaim to avoid the interest under Section 544(a) of the Bankruptcy Code, allowing a trustee to avoid interests in debtor's property that are unperfected as of the petition date. The trustee claimed the description by reference in the UCC financing statement was not sufficient. The bankruptcy court agreed with the trustee, noting that a "financing statement that fails to contain any description of collateral fails to give the particularized kind of notice" required by Article 9 of the UCC. The trustee sold the assets Debtor for $1.9 million and held the proceeds pending resolution of the dispute.

The Seventh Circuit decided whether the collateral description in a UCC financing statement is sufficient when it only references another document which is not attached to the security agreement. UCC 9-502 requires that the financing statement "indicates the collateral covered by the financing statement." UCC 9-504 provides: "A financing statement sufficiently indicates the collateral that it covers if the financing statement provides: (1) a description of the collateral pursuant to Section 9-108; or (2) an indication that the financing statement covers all assets or all personal property."

UCC 9-108(a) provides that the financing statement sufficiently describes the collateral "whether or not it is specific, if it reasonably identifies what is described." Subsection (b) lists six examples, such as listing, category, type, quantity or formula. Bank's financing statement did not meet the first five examples. The sixth example, however, is a catch-all permitting "any other method, if the identity of the collateral is objectively determinable." The Circuit focused on this aspect and that a financing statement does not require the same level of detail as a security agreement: "the financing statement provides notice of an underlying security interest, while the security agreement creates and specifically defines that interest." There was no dispute about the sufficiency of Bank's collateral description in the Security Agreement.

Circuit also noted the Illinois bankruptcy courts' recognition that incorporation by reference is an example of the "any other method" of describing collateral as permitted by UCC 9-104. Despite the vague description, the Circuit also found that Bank's financing statement sufficiently notified subsequent creditors that a lien may exist. On that basis, the Seventh Circuit reversed the bankruptcy court and held that the trustee was not entitled to avoid Bank's lien under the Code and that the identity of the collateral was be "objectively determinable" as required by the UCC. Bank, as the secured creditor, was entitled to the $1.9 million.

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Eighth Circuit

***Ronnoco Coffee, LLC, et al. v. Westfeldt Brothers, Inc*., No. 18-1498, 2019 WL 4492665 (8th Cir. Sept. 19, 2019).**

In a recent decision, the Eighth Circuit affirmed the District Court's holding that a corporation does not take on successor liability simply by acquiring substantially all the assets of an unrelated competitor through a secured creditor's private foreclosure sale under Iowa law. In so holding, the Eighth Circuit noted that it followed "[t]he well-settled general rule, adopted in virtually every State."

Ronnoco Coffee began discussions to acquire a competing coffee roasting company, but eventually decided not to acquire the competitor because it had substantial debt obligations. Approximately a year later, Ronnoco Coffee learned that the competitor's bank foreclosed on its blanket lien on all of the competitor's assets. Subsequently, Ronnoco formed a new entity specifically to acquire the assets out of foreclosure and entered into a sale agreement with the bank that expressly provided that the acquisition did not involve any assumption of liabilities or obligations. After the acquisition, Ronnoco continued coffee roasting operations at the former

competitor's old location, retained most of the employees, and even retained the former President and the former CFO for ten and six months respectively.

Westfeldt supplied unprocessed coffee beans to the former competitor. Prior to the bank's foreclosure of the blanket lien, Westfeldt began requiring that the former competitor make a payment toward old invoices in excess of the amount of any new order before it would ship. However, Westfeldt did not obtain a purchase money security interest in any of the coffee it shipped.

After the acquisition, Ronnoco commenced an action seeking declaratory judgment that it was not liable for the former competitor's debts and did not assume obligations to perform future coffee supply contracts. Westfeldt asserted counterclaims for successor liability, breach of the future contracts, unfair trade practices, conversion, and unjust enrichment. The district court eventually entered summary judgment in favor of Ronnoco because Westfeldt failed to submit evidence that the foreclosure sale and asset sale were anything but bona fide business transactions.

In affirming the district court's decision, the Eighth Circuit first noted that in almost every state the rule is that "where one company sells or otherwise transfers all its assets to another company, the latter is not liable for the debts and liabilities of the transferor" unless there is an express or implied agreement to assume liabilities, the transfer is a de factor corporate merger, where the transaction was fraudulent, or where the purchaser is a "mere continuation" of the seller.

Westfeldt unsuccessfully argued that Ronnoco was a continuation of its former competitor's business and that the transaction was fraudulent. Applying Iowa law, the Eighth Circuit rejected Westfeldt's argument that Ronnoco continued the former competitor's business because the question is not whether the acquirer continues the transferor's business operation, but rather whether the acquirer is a continuation of the corporate entity of the transferor. Pointing out that Iowa courts "have never applied the mere continuation exception where the buying and selling corporations had different owners," the Eighth Circuit held that merely retaining the President and CFO for a short transition period is not enough to establish that the buyer is a continuation of the company whose assets were acquired.

The Eighth Circuit also rejected Westfeldt's argument that Ronnoco and the former competitor had conspired to "plac[e] assets beyond the reach of creditors" because the assets were not acquired directly from the former competitor, but rather from the secured lender that foreclosed on those assets. Equally important, the Eighth Circuit found that Westfeldt failed to establish the damages element of fraud because the secured lender had a deficiency in excess of $3 million after selling the assets to Ronnoco for an amount that was undisputedly a commercially reasonable price. Since the former competitor could not have paid all of its secured debt and made a payment toward Westfeldt's unsecured claim, Westfeldt was not damaged.

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Ninth Circuit

***United States Dep't of Agric. v. Hopper (In re Colusa Reg'l Med. Ctr.),* No. EC-18-1266-TaBS, 2019 Bankr. LEXIS 3123, 2019 WL 4398419 (B.A.P. 9th Cir. Sep. 10, 2019**).

In *Colusa Regional Medical Center*, the Ninth Circuit BAP concluded that the lower court erred by allowing a Chapter 7 Trustee (the "Trustee") to surcharge the United States Department of Agriculture's (the "USDA") collateral for payment of his attorney's fees and his statutory fees.

When Colusa Regional Medical Center (the "Debtor") filed its Chapter 7 petition, it left the residents of Colusa County without medical services and forced residents to travel between 30 and 45 minutes to the nearest hospital. The USDA held a senior security interest in a number of the Debtor's assets including equipment, accounts receivable, and a real property lease. The Trustee sold the Debtor's assets as a going-concern under § 363. The sale allowed the purchaser to open a new hospital to address the demand left from termination of the Debtor's operations.

After the sale, the Trustee filed a motion to surcharge the USDA's remaining cash collateral under § 506(c). The Bankruptcy Court found that the Trustee's actions objectively benefitted the USDA because the Trustee collected accounts receivable that were subject to the USDA's security interest. The Bankruptcy Court further found that the USDA implicitly consented to the surcharge because the only reason that the Trustee pursued a sale as a going-concern was to meet the "USDA's twin desires" of ensuring that medical services were available in Colusa County and collecting the Debtor's outstanding accounts receivable.

The BAP disagreed. First, the BAP held that the surcharge was not authorized under the "objective test" that requires the moving party prove that the requested expenses were "necessary, reasonable, and of specifically identifiable and tangible benefit to the secured creditor" and "more than just incidental from the perspective of collateral preservation." The BAP reasoned that the Trustee's recovery of the accounts receivable, financed through use of the USDA's own cash collateral, was not a sufficient benefit for surcharge purposes. Furthermore, the sale of the Debtor's operation as a going-concern benefitted the Debtor's estate as a whole and only incidentally benefitted the USDA.

Second, the BAP rejected the argument that the USDA consented to the surcharge. The BAP explained that implied consent requires "either some direct creditor action to cause the expense or some inaction that suggests an understanding that it is otherwise receiving a windfall." The BAP found that the USDA's willingness to help the Trustee to complete the sale and its desire to have adequate medical services in Colusa was insufficient to satisfy the consent test.

Therefore, the BAP concluded that the Bankruptcy Court erred by permitting a surcharge and vacated and remanded the Bankruptcy Court's decision.

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Tenth Circuit

***Connolly v. Asbestos Abatement, Inc. (In re Iley)*, Adv. Pro. No. 17-1519 EEB, 2019 WL 4535590 (Bankr. D. Colo. Sept. 17, 2019).**

In *Connolly v. Asbestos Abatement, Inc. (In re Iley)*, Adv. Pro. No. 17-1519 EEB, 2019 WL 4535590 (Bankr. D. Colo. Sept. 17, 2019), the bankruptcy court held that, to the extent that funds paid to the IRS on behalf of the defendant were trust funds contemplated by 26 U.S.C. § 7501, payments of those monies could not be avoided as preferential transfers in violation of Section 547(b) of the Bankruptcy Code. Connolly was the chapter 7 trustee for the estates of the debtors, Mr. Iley and his tax and accounting firm. Mr. Iley began a fraudulent scheme whereby he would keep clients' funds that were to be used to pay payroll taxes as he would surreptitiously modify the clients' tax returns to reflect no payroll taxes were due. The defendant was a payroll client of the firm and victim of the scheme perpetrated by the firm's principal. After learning of the scheme, the defendant and other firm clients made payments to them or to the IRS on their behalf. The firm made 8 payments to the IRS, as requested, on behalf of the defendant totaling $327,732.18. The court concluded that the amounts deducted by the firm for the defendant's employer matching portion of FICA, Medicare taxes and FUTA, and state tax liabilities, were not trust fund taxes under Section 7501, but that the amounts for employee FICA withholding, employee Medicare withholding and federal withholding were trust fund taxes. Accordingly, the defendant was entitled to summary judgment as to the tax liability payments considered trust fund taxes under Section 7501.

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