Bankruptcy Briefs

Newsletter of the Bankruptcy Section of the Federal Bar Association

L. Kathleen Harrell-Latham, Editor

Summer 2011

Message from the Chair

by Marc Taubenfeld

It has been a busy year and the section is thrilled to once again be assisting in a CLE at the 2011 FBA Annual Meeting and Convention, which will be held in Chicago on September 8th-10th. There will be a panel discussion on Ponzi schemes with Irving Picard, Baker & Hoestetler, Douglas Kelley, Kelley, Wolter & Scott PA, Douglas Baird, Harry A. Bigelow Distinguished Service Professor of Law University of Chicago Law School, and Ronald R. Peterson, Jenner & Block. This will certainly be a lively discussion and they will definitely have some fantastic insights into a number of the highest profile Ponzi cases of the past few years and the continuing fall-out. The panel also plans to cover the interesting issues of forfeiture, clawbacks, and even the recent US Supreme Court case of *Stern v. Marshall*. The CLE will start at 11:15 a.m. on Friday, September 9, 2011 and will go until 12:30 pm.

There will also be a brief business meeting after the CLE. The business meeting will be very short and we plan to announce the slate of officers for the upcoming year, entertain nominations from the floor, and vote on the slate, as well as take questions and comments from section members.

Reception for Section Members honoring Chicago Bankruptcy Judges

You are all invited to attend the reception honoring the Chicago bankruptcy judges that will be hosted by the Section. The reception will be from 4:00 pm to 5:30 pm on Friday September 9, 2011. It will be held at the Chi Bar, 301 East North Water Street, Chicago, which is on the lobby level of the convention site (the Sheraton Chicago Hotel & Towers). Please remember to send in your RSVP's so that we can get a final head count for catering purposes.

Publishing Bankruptcy Articles

Our section has previously solicited and edited bankruptcy related articles and judicial profiles for *The Federal Lawyer.* The section continues to look forward to opportunities to submit additional bankruptcy related content to the premier magazine of the Federal Bar Association. Please contact myself or any of the section leadership with any ideas or articles that you may have and we'll work on the publication logistics.

Leadership Ladder

The Section happily added a number of people to the board and leadership ladder mid-year after soliciting applicants section-wide. The new officers are: Rob Weber, Skadden Arps in Wilmington, Delaware, as Treasurer; and L. Kathleen Harrell-Latham, Larkin Hoffman in Minneapolis, Minnesota, as Secretary (Kathy is also one of our circuit writers); and the two new at-large members are Tristan Manthey, Heller Draper Hayden Patrick & Horn LLC in New Orleans, Louisiana (Tristan is also one of our circuit writers), and John Voorhees, Mayer Brown in Chicago, Illinois. Richard Ziegler, Mayer Brown in Chicago, Illinois, has also been added as a member of the CLE Programming and Outreach Committee. Welcome! In addition, our leadership ladder is intact, as follows:

Chair
Marc Taubenfeld

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Secretary
L. Kathleen Harrell-Latham

Immediate Past Chair
Judge Janice M. Karlin

The leadership ladder will keep on moving and the Section will be in need of a new Secretary in October. We are excited to, once again, solicit a new addition to the Section's leadership ladder. Please forward your statements of interest and CV to me at mtaubenfeld@mcslaw.com if you are interested in being considered for an appointment as the section's secretary starting in October.

Circuit Summary Writers

The circuit summary writing project continues and the volunteers are doing a fantastic job of summarizing circuit-level bankruptcy related and BAP opinions which are then distributed in weekly emails to the membership at-large. These emails are a fantastic way to keep updated and it comes straight to your inbox! You can even head to the Section's website to locate the updates (by circuit and by week) if you miss the emails or want another look.

The circuit writers have agreed to help the section for a term of one year. The work has been fantastic and almost every circuit has volunteers. The Section is always looking for additional volunteers to help fill the circuit writers spots or to help those who have already volunteered. If interested, please contact Sherwin Valerio, the new manager of Sections and Divisions, at svalerio@fedbar.org to add your name to the list and get started with helping to write the case summaries for your circuit!

Thank you again to all of you who have served as volunteers for the 2010-2011 year:

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Article III Bars Anna Nicole Smith's Core Counterclaim and Shakes up the Bankruptcy World

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Bankruptcy Extern for the Honorable Harlin D. Hale -- Spring 2011

The Anna Nicole Smith ("Vickie") saga came to an end on June 23, 2011. On that day, the United States Supreme Court rendered a decision that will likely have a large impact on many future Bankruptcy proceedings. The question posed to the Court was (1) whether the Bankruptcy Court had the statutory authority under 28 U.S.C. sec. 157(b) to issue a final judgment on Vickie's counterclaim; and (2) if so, whether conferring that authority on the Bankruptcy Court is constitutional. In a 5-4 opinion delivered by Chief Justice Roberts, the majority held that although sec. 157(b)(5) did indeed allow the non-Article III court to enter a final judgment on Vickie's tortious interference counterclaim, the Bankruptcy Court lacked the constitutional authority to do so.

The Background

After she was left out of J. Howard Marshall's will, Vickie filed for bankruptcy in California. There, Pierce Marshall, J. Howard's son, filed a proof of claim in a defamation action against Vickie seeking to recover damages from her estate. Vickie filed a counterclaim against Pierce for tortious interference stemming from a dispute over the late tycoon's oil fortune. There, the court award Vickie summary judgment against Pierce in the defamation claim and compensatory and punitive damages totaling more than $425 million dollars. A number of appeals followed and after a trip to the 9th Circuit and the Supreme Court and a subsequent remand to the 9th Circuit, the case ended up back in the Supreme Court for final adjudication and a decision that could profoundly affect bankruptcy, district and state courts.

The Statute from a Plain Text Lens

Under the Code, a bankruptcy court may enter a final judgment in any core proceeding "arising under Title 11, or arising in a case under Title 11." Sec 157(b)(1). The statute sets forth a non-exhaustive list of 16 matters that constitute core proceedings; one of which is counterclaims by the estate against persons filing claims against the estate. 157(b)(2)(C). If a bankruptcy judge deems a proceeding to be non-core, he may not enter final judgment, but rather, "submit proposed findings of fact and conclusions of law to the District Court." 157(b)(2)(C).

With this language in mind the Supreme Court held, contrary to Pierce's arguments, that the statute indeed covered the counterclaim. Pierce's argued that there was a whole other category of cases that were core but did not arise in or under a Title 11 case. This, the majority quickly dismissed. The Court cited the fact that if this were so it would leave serious doubt as to how to dispose of a core proceeding that didn't arise in or under a Title 11 case. If there was any doubt of the Court's resoluteness in this matter, it was removed by Justice Roberts' statement: "oxymoron is not a typical feature of the congressional drafting." Opinion at 10.

Pierce argued in the alternative that the section 157(b)(5) requirement, that personal injury and wrongful death tort suits be decided in district courts, was jurisdictional. The Court pointed out that the statute was not framed in a jurisdictional light and the courts are loathe to impose a jurisdictional bar when there is none to begin with. The lack of jurisdictional framing meant that Pierce could waive his right to a district court hearing and had no right to complain when the case did not produce a favorable result.

The Constitutional Door Slams in Vickie's Face

Although the majority found that the statute covered the counterclaim, the slim majority held that it was unconstitutional for a non-Article III court to adjudicate the claim. The court noted the need to reinforce the integrity of the separation of powers, and more specifically that of the judicial branch, by ensuring that cases such as the one at bar are decided by judges that enjoy the protections of salary and lifetime tenure.

The Court addressed Vickie's public right argument in great detail. The Justices wrote that although the plurality in *Northern Pipeline* acknowledged a public right wherein Congress could constitutionally refer a claim to a non-Article III decision maker, such as a Federal Agency, the case at bar did not constitute such a case. In addressing the public right question, the Court noted that Vickie's claim did not stem from a federally regulated statutory scheme nor did it even arise out of a federal cause of action that could be quickly and efficiently adjudicated by a specialized agency. Rather, Article III courts are experts in the field of common law causes of action.

Finally, since the Bankruptcy courts are adjuncts of no court, the majority was concerned that the Bankruptcy Court wielded the full "judicial power of the United States" by entering binding orders and making findings of fact. Orders that the District Courts can only review under "limited appellate standards."

Is There a Nexus?

In adjudicating the constitutionality of a non-Article III court entering final judgment in this core proceeding, the majority also looked to the nature of Pierce's initial proof of claim, Vickie's counterclaim, and any relevant nexus between the two causes of action. The court find no such nexus. Rather, the Justices pointed out that even in *Katchen*, where the trustee's voidable preference claim was essential in deciding whether to allow the creditor's claim, the court expressed no opinion as to a Bankruptcy Judge's ability to exercise "summary jurisdiction to adjudicate a demand by the trustee for affirmative relief." Opinion at 31.

Policy Concerns Don't Concern this Decision

Finally, in response to the concern that this holding would create a profound change in the District Court caseload, the Majority submitted that constitutional concerns should always trump judicial efficiency and indeed there was a real threat to the Article III in the case at bar. Justice Roberts artfully stated that "a statute may no more lawfully chip away at the authority of the Judicial Branch that it may eliminate it entirely." Opinion at 37.

Scalia Concurs and Critiques

Justice Scalia concurred with the Majority but was troubled by the Majority's reasoning, particularly that "the tests suggested by [the Court's] jurisprudence…have nothing to do with the test or tradition of Article III." Concurrence at 2. Scalia's reasoning was simple: Article III judges must adjudicate *all* federal causes of action under the text of Article III.

The Dissent Takes a Pragmatic Approach

Four Justices dissented. Although they agreed with the majority that section 157(b)(2)(C) permitted the bankruptcy court to enter a final judgment on the core counterclaim, the dissent would have gone further and held that the statute is constitutional and does not violate Article III. The Dissent applied a pragmatic and functional approach to address Vickie's core counterclaim. The dissent sought to undermine the majority by pointing out a misplaced reliance on certain precedent. For example, the Minority stated that the holding of Murray's Lessee has been used by later courts to *uphold*[ ] non-Article III adjudication, not…strik[e] it down." Dissent at 3 (emphasis in original). Conversely, the Dissent was disheartened at the lack of treatment and analysis paid to the Crowell holding ("Were Crowell's holding as narrow as the Majority suggests, one could question the validity of Congress' delegation of authority to adjudicate disputes among private parties to other agencies as the National Labor Relations Board" and other similar agencies) *Id*. at 5.

The Dissent was not comforted by the Majority's prediction that the Stern v. Marshall holding "[did] not change all that much." 16. To the four justice, this ruling will likely have debilitating effects on the judicial systems, forcing Article III courts to hear common, but now barred compulsory counterclaims in commonplace bankruptcy proceedings. *Id*. at 17.

Conclusion

Like many Supreme Court decisions, the impact of this holding awaits interpretation in the lower courts. Undoubtedly, the Bankruptcy Courts' ability to adjudicate counterclaims like the one presented in the instant case is over. However, given the sweeping language of the Majority opinion and the concern over a violation of Article III, one might argue that other issues regularly considered by the Bankruptcy Courts might now be handed over to the district or state courts for final resolution.

The Cow Does Not Follow the Tail: A Stricter Approach to Foreclosure Cases

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How should courts address the "show me the note" defense of consumer debtors against lenders in foreclosure cases? The Ninth Circuit Bankruptcy Appellate Panel answered that question with an in-depth discussion of standing in *In re Veal*, BAP AZ-10-1055, 2011 WL 2652328 (B.A.P. 9th Cir. June 10, 2011). The legal analysis provided in this opinion is likely to have a significant impact on foreclosure decisions nationwide.

The court in *In re Veal* explained that prudential standing to seek relief from the automatic stay requires a party to show either that the movant is a person entitled to enforce the note (which normally requires possession of the note) or the party otherwise had some ownership or other property interest in the note. *Id.* at *10, *14. If a party is trying to prove some ownership or other property interest in the note, the court held that evidence relating to the assignment of the mortgage fails the standing requirement when the underlying note is not explicitly included. *Id.* at *12–13. This result occurs because the transferred mortgage is ineffective and unenforceable if it is not transferred with the underlying note. *Id*. Standing requirements for proof of claims for servicers present similar issues: the court held that a party in this position must show that either it was a "person entitled to enforce" the note, or was the agent of such a person. *Id.* at *10.

The Background

Meet the Debtors: The Veals

In August 2006, Shelli Veal executed a promissory note (the "Note") in favor of GSF Mortgage Corporation (GSF). *Id.* at *1. Ms. Veal also executed a mortgage (the "Mortgage") in favor of GSF to secure her payment obligations under the note. *Id*. On June 29, 2009, the Veals filed a chapter 13 bankruptcy. *Id*.

Meet the Alleged Creditor and its Servicing Agent: Wells Fargo and AHMSI

On July 18, 2009, American Home Mortgage Servicing, Inc. (AHMSI) filed a proof of secured claim. *Id*. AHMSI stated in the claim that AHMSI was filing on behalf of Wells Fargo as Wells Fargo's servicing agent. *Id*.

On October 21, 2009, Wells Fargo filed a motion for relief from stay to enable it to commence foreclosure proceedings against the property covered by the Mortgage. *Id.* at *2.

The Lower Court

The following evidence was provided in these two related cases:

(1) Both AHMSI and Wells Fargo provided a copy of the Note, showing an indorsement from GSF to Option One Mortgage Corporation (Option One);
(2) both AHMSI and Wells Fargo provided a copy of the Mortgage;
(3) both AHMSI and Wells Fargo provided a copy of a recorded "Assignment of Mortgage," assigning the Mortgage from GSF to Option One;
(4) AHMSI provided a letter dated May 15, 2008 from the Executive Vice President and Chief of Legal Officer of AHMSI stating that AHMSI acquired Option One's mortgage servicing business; and
(5) Wells Fargo provided a copy of an unauthenticated assignment of mortgage, dated November 10, 2009, assigning the rights under the Mortgage from "Sand Canyon Corporation formerly known as Option One Mortgage Corporation" to Wells Fargo.

Id. at *2–3. On November 5, 2009, the Veals filed an objection to AHMSI's proof of claim, claiming, among other objections, that AHMSI lacked standing based on the evidence produced. *Id.* at *2. On the same day, the Veals also responded to Wells Fargo's relief from stay motion. *Id.* at *3. The Veals argued that Wells Fargo lacked standing to prosecute the relief from stay motion and that Wells Fargo was not the real party in interest. *Id*.

The United States Bankruptcy Court for the District of Arizona overruled the Veal's claim objection to AHMSI and granted Wells Fargo's relief from stay motion. *Id.* at *4. The Veals timely appealed both orders to the Ninth Circuit Bankruptcy Appellate Panel. *Id*.

The Outcome

Wells Fargo's Standing Requirement to Seek Relief from the Automatic Stay

As stated by the Bankruptcy Appellate Panel, Wells Fargo had "the burden of establishing its status as a real party in interest allowing it to move for relief from stay, as this is the way in which Wells Fargo satisfies its prudential standing requirement." *Id.* at *13. The court described two ways in which Wells Fargo could meet the standing requirement to seek relief from the automatic stay. *Id.* at *10, *13.

I. Person entitled to enforce the note

The first way is by showing proof of being a "person entitled to enforce the note." *Id.* at *7. This analysis is done under the Uniform Commercial Code ("UCC") Article 3, and three different methods of acquiring the status of "person entitled to enforce" the Note under Article 3 are discussed. *Id.* at *8 & n.22.

The first method is to be a holder, which requires possession of the note and either (i) the note being made payable to the person in possession, or (ii) the note being made payable to the bearer of the note. *Id.* at *8 (citing UCC 1–201(b)(21)(A)). Thus, this determination requires physical examination of both the face of the note and any indorsements made. *Id*. Being a holder of the note is the most common method of acquiring the "person entitled to enforce" status. *Id*.

The second method is for a person to attain the status of a "non-holder in possession of the [note] who has the rights of a holder." *Id.* (alteration in original) (citing UCC § 3–301(ii)). The most common way in which this occurs is when the physical delivery of the note to a person constitutes a "transfer" but not a "negotiation." *Id.* at *8; *compare* UCC § 3–201 (definition of negotiation) *with* UCC § 3–203(a) (definition of transfer). As stated by the court:

> Under the UCC, a "transfer" of a negotiable instrument "vests in the transferee any right of the transferor to enforce the instrument." UCC§ 3–203(b). As a result, if a holder transfers the note to another person by a process not involving an Article 3 negotiation—such as a sale of notes in bulk without individual indorsement of each note—that other person (the transferee) obtains from the holder the

right to enforce the note even if no negotiation takes place and, thus, the transferee does not become an Article 3 "holder."

In re Veal, 2011 WL 2652328, at *8. The court acknowledged this puts "a great deal of weight on the UCC's definition of a 'transfer.'" *Id. See also* UCC § 3–203(a) ("An instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument."). Thus, possessing a note that has not been indorsed by the payee or other holder does not prevent a person from being the "person entitled to enforce the note." *In re Veal*, 2011 WL 2652328, at *8. As acknowledged by the court though, "it does raise the stakes." *Id*. The person in possession of the note "must demonstrate both the fact of the delivery and the purpose of the delivery of the note to the transferee in order to qualify as the 'person entitled to enforce.'" *Id*.

The third method does not require possession of the note, but it is less common. *Id.* at *8 n.22. As explained by the court:

Under UCC § 3–301(iii), a person may be a "person entitled to enforce the note" if, among other things, "the person cannot reasonably obtain possession of the instrument because the instrument was destroyed, its whereabouts cannot be determined, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process." UCC § 3–309(a)(3).

Id. The court found that Wells Fargo failed to show that it or its agent had actual possession of the note, and Wells Fargo offered no evidence of the note being stolen, destroyed, or lost. *Id.* at *14. As a result, the court held that Wells Fargo was not a person entitled to enforce the note. *Id*.

II. Some ownership or other property interest in the note

Showing some ownership or other property interest in a note can also satisfy the prudential standing requirement by establishing a party's status as a real party in interest, which allows the party to seek stay relief. *Id.* at *9. The initial owner of a note is the payee to whom it was issued. *Id*. If the payee transfers the note in a manner not contemplated by Article 3, Article 9 of the UCC applies and determines whether property interest in the note is obtained by the purchaser of the note. *Id*. Common law may also apply to transfers of the note or mortgage. *Id.* at 12–13. Under the common law, when it comes to the assignment of a mortgage and its effect on the underlying note, there are two views.

The first view is that "without the assignment of the [note], the assignment of the [mortgage] is a nullity." *See Armacost v. HSBC Bank USA*, 10-CV-274-EJL-LMB, 2011 WL 825151, at *10 (D. Idaho Feb. 9, 2011) (citing *Laboissiere v. GMAC Mortgage*, 2010 WL 2836107 (D. Idaho)) ("[H]aving an assignment of the deed is not sufficient, because the security follows the obligation secured, rather than the other way around." quoting *In re Jacobson*, 402 B.R. 359, 367 (Bankr. W.D. Wash. 2009)) *report and recommendation adopted*, 1:10-CV-00274-EJL, 2011 WL 809166 (D. Idaho Mar. 2, 2011).

The second view is that the assignment of the mortgage also assigns the note, unless there is an indication of the parties' intent not to assign the debt. *See id*. This view has been adopted by the *Restatement (Third) of Property*. *See Restatement (Third) of Property (Mortgage)* § 5.4(b) (1997) ("Except as otherwise required by the Uniform Commercial Code, a transfer of a mortgage also transfers the obligation the mortgage secures unless the parties to the transfer agree otherwise.").

The court in *In re Veal* clearly preferred the first view. There were two purported assignments in this case. *In re Veal*, 2011 WL 2652328, at *3. The first was the purported assignment from GSF (the initial owner) to Option One, which was properly indorsed. *Id*. This assignment also "assigned not only the Mortgage, but also 'the note(s) and obligations therein described and the money due and to become due thereon with interest, and all rights accrued or to accrue under such Mortgage.'" *Id*. While this contractual assignment was unnecessary, given the indorsement on the original note, the court noted that this language would be sufficient to transfer both the note and the mortgage without the indorsement. *Id.* at *3 & n.6.

The second purported assignment from Option One to Wells Fargo is the one viewed by the court as problematic. *Id.* at *3. This assignment purported to transfer

the following described mortgage, securing the payment of a certain promissory note(s) for the sum listed below, together with all rights therein and thereto, all liens created or secured thereby, all obligations therein described, the money due and to become due thereon with interest, and all rights accrued or to accrue under such mortgage.

Id. The court found this language too vague to include the note in the transfer: "It would be odd indeed if, after referring to the Note but not explicitly making it the object of the transfer (as the initial assignment from GSF did), the words were made to curl back and pick up the Note among its many terms." *Id.* at *3 n.7. Because this second purported assignment was "devoid of any indorsement of the Note from Option One to Wells Fargo" and did "not contain language effecting an assignment of the Note," the court found that it could not provide proof of a transfer of the Note to Wells Fargo. *Id.* at *3.

If the assignment of the Mortgage does not also assign the Note, the situation is as described by the late Professor Chester Smith of the University of Arizona College of Law: The note is the cow and the mortgage the tail. The cow can survive without a tail, but the tail cannot survive without the cow. *Armacost*, 2011 WL 825151, at *10 n.12 (D. Idaho Feb. 9, 2011) *report and recommendation adopted*, 1:10-CV-00274-EJL, 2011 WL 809166 (D. Idaho Mar. 2, 2011) (quoting *Best Fertilizers of Arizona, Inc. v. Burns*, 571 P.2d 675, 676 (Ariz. Ct. App. 1977), *reversed on other grounds*, 570 P.2d 179 (Ariz. 1977)). To apply this analogy to the court's finding in *In re Veal*: Wells Fargo could only show proof of the tail assignment, which the court viewed as a nullity without the assignment of the cow as well. To state the court's view another way: The tail will follow the cow, but the cow does not follow the tail. *See In re Veal*, 2011 WL 2652328, at *13 ("An assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity." (quoting *Carpenter v. Longan*, 83 U.S. 271, 274–75 (1872))).

Based on these findings, the court reversed the bankruptcy court's grant of Wells Fargo's motion for relief from stay. *Id.* at *14.

AHMSI's Standing Requirement to File Proof of Claim

The prudential standing requirement for AHMSI was to establish its status as the real party in interest in order to file a proof of claim with respect to the Note. *Id.* at *16. The court found that for AHMSI to satisfy standing it had to show either evidence that it was the agent of Wells Fargo or that either AHMSI or Wells Fargo was a "person entitled to enforce" the Note. *Id*. The court found that AHMSI failed to provide evidence for any of these ways to establish standing, and the court vacated and remanded for further fact findings. *Id.* at *18.

The Future

The Ninth Circuit Bankruptcy Appellate Panel has put its foot down in reaction to shoddy evidence and a lack of proper documentation when it comes to transferring notes. Fear of mistaken payments appears to be one of the court's main concerns. *See id.* at *16 ("the primary purpose of the real party in interest doctrine is to ensure that such mistaken payments do not occur").

This stricter approach to foreclosures that focuses on following the ownership of the note is in conflict with the current trend of some state courts (notably in California), as acknowledged by the court. *Id.* at *13 n.34 ("We are aware of statutory law and unreported cases in this circuit that may give lenders a nonbankruptcy right to commence foreclosure based solely upon their status as assignees of a mortgage or deed of trust, and without any explicit requirement that they have an interest in the note."). The end result of this split between certain state courts and the bankruptcy courts in the Ninth Circuit is uncertain. A possible outcome in the interim is that debtors in these state courts may increasingly prefer the stricter approach of bankruptcy courts. *See* Dan Schechter, *Purported Assignee of Mortgage Lacks Standing to Obtain Relief from Automatic Stay Because Assignment Transferred Mortgage Without Underlying Note*, COMMERCIAL FINANCE NEWSLETTER, June 27, 2011, *available at* 2011 Comm. Fin. News. 52 ("Based on these cloudy and muddled tea leaves, I predict that California debtors facing foreclosure will increasingly avoid the state courts and will instead try to use the bankruptcy courts, in order to assert the 'show me the note' defense to foreclosure.").

Fifth Circuit Decision Regarding Standing, Judicial Estoppel, and Res Judicata

Spicer v. Laguna Madre Oil & Gas II, L.L.C.,

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This was an appeal from the bankruptcy court's denial of Laguna Madre Oil & Gas II, L.L.C. ("Laguna") motion for summary judgment. Texas Wyoming Drilling, Inc. ("TWD") filed for chapter 11 bankruptcy. Shortly thereafter, the court approved both TWD's plan and disclosure statement. The central issue at hand is whether the terms of the plan preserved TWD's claims against Laguna.

In TWD's plan it specifically states that, "the reorganized Debtor shall retain all rights, claims, defenses, and causes of action including, but not limited to, the Estate Actions (defined as claims under Chapter 5 of the bankruptcy code), and shall have the sole authority to prosecute and/or settle such actions." Accordingly, TWD's disclosure statement includes a clause very similar to the one described in TWD's plan and in addition includes "any actions applicable under state laws" and actions under sections 542 and 549 of the Bankruptcy Code. In fact, the disclosure statement goes even further as to include specific claims that the Debtor may pursue on behalf of the estate. One of the potential Defendants in such actions is "Various pre-petition shareholders of the Debtor" who could be sued for "fraudulent transfer and recovery of dividends paid to shareholders." These claims are valued at approximately $4 million.

Shortly after confirmation of the plan, TWD sued thirty-two former shareholders alleging that the shareholders had received dividends and other transfers totaling millions of dollars while TWD was insolvent ("Avoidance Actions"). TWD prayed for pre-petition dividend payments, which as stated above, were allegedly fraudulent transfers.

Upon commencement of the aforementioned Avoidance Actions, Laguna filed a motion for summary judgment arguing that 1) TWD had no standing for such action, 2) such action was barred by the doctrine of judicial estoppel, and 3) such action was barred by the doctrine of *res judicata*. Interestingly, the day before Laguna's motion was to be heard, the bankruptcy court, *sua sponte*, converted TWD's Chapter 11 bankruptcy to a Chapter 7 bankruptcy due to the fact that TWD had materially defaulted on their plan. The trustee then substituted for TWD as plaintiff in the Avoidance Actions and the bankruptcy court denied Laguna's motion for summary judgment. Upon Laguna's request, the order was certified by the bankruptcy court for immediate appeal and the Fifth Circuit granted Laguna's petition for permission to appeal. The Fifth Circuit discussed all three of Laguna's arguments.

I. Standing

As was stated in *In re United Operating*, "For a Debtor to preserve a claim, the plan must expressly retain the right to pursue such actions. The reservation must be specific and unequivocal." This statement hits the nail on the head with regards to the overriding issue of this appeal: Whether TWD's reservation is specific enough to be preserved and justiciable. Laguna's first argues that all the court is to look at when determining standing is the plan. Laguna urges that the court may not consider the disclosure statement alongside the plan in order to determine whether TWD has standing. However, the court directs Laguna to *Floyd v. CIBC World Markets*, which states, "Courts are to consider the disclosure statement as well as the terms of a plan of reorganization." The problem lies in the fact that the pertinent statute, § 1123(b)(3)(B), does not state, explicitly or implicitly, whether claims can be preserved in a disclosure statement. This court held that "courts may consult the disclosure statement in addition to the plan to determine whether a post-confirmation debtor has standing."

Laguna then refers to this courts precedent in *In re United Operating* where a Debtor, post confirmation of its plan, attempted to bring common law claims against its creditor. However, unlike the plan in *In re United Operating*, which contained only a blanket reservation for "any and all" claims, TWD's plan and disclosure statement clearly "revealed the existence of the Avoidance Actions, the possible amount of recovery to which they would lead, the basis for the actions, and that the reorganized debtor intended to pursue the claims." It became clear that the terms of TWD's plan and disclosure statement are far more specific than those in *In re United Operating*.

The Fifth Circuit ultimately held that when the plan and disclosure statement reserve the right to pursue the Avoidance Actions against the shareholders of TWD, "the reorganized debtor specifically and unequivocally retained these claims."

II. Judicial Estoppel

In the alternative, Laguna argued that the Trustee is judicially estopped from pursuing the Avoidance Actions due to the fact that TWD failed to disclose them on its schedules. A problem for Laguna arises in that TWD did not take "clearly inconsistent positions"; both TWD's plan and disclosure statement retained the right to pursue the Avoidance Actions.

Since TWD explicitly reserved the claims that the Trustee is now pursuing, there is no inconsistency in TWD's positions. Thus, the bankruptcy court's ruling that the Trustee was not judicially estopped from pursuing the Avoidance Actions was not an abuse of discretion.

III. *Res Judicata*

In the alternative, Laguna also argues that the Avoidance Actions are barred by the doctrine of *res judicata*. Laguna's *res judicata* argument rests on the bankruptcy court's order confirming TWD's plan. However, in bankruptcy cases, the confirmation order is the first judgment and in order for *res judicata* to apply, there must have been a final judgment on the merits. Accordingly, the Fifth Circuit states, "*Res Judicata* does not apply here. The defendants have not pointed to a prior final judgment on the merits of the Avoidance Actions."

Furthermore, the court points to *Ries v. Paige*, which stated, "*Res Judicata* does not apply where a claim is expressly reserved by the litigant in the earlier bankruptcy proceeding."

With regards to the argument of *res judicata*, the Fifth Circuit concluded that because the confirmation order preserved the Avoidance Actions, they are not barred by *res judicata*.

IV. Conclusion

Overall, the Fifth Circuit found that "the bankruptcy court properly denied Laguna's motion for summary judgment because the plan adequately preserved the Avoidance Actions and the claims were not barred by judicial estoppel or *res judicata*." Accordingly, the ruling was affirmed.

Fifth Circuit Politely Declines Creative New Dish

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Boudreaux and Thibodeaux were walking through the woods the other day, when a flying saucer landed near them. A door opened, and two little green aliens climbed down out of the spacecraft. Thibodeaux asks Boudreaux, "Mais, look at dat. What you tink dat is?" Boudreaux, aiming his shotgun at the little space critters, tells him, "Thibodeaux, I don't know, but you hurry back to de camp, and start making a roux and put on a pot of rice!"

Folks down in the Bayou know how to serve up creative new dishes.[1] A bankruptcy court in Louisiana recently served up one such dish, but the Fifth Circuit politely declined. Specifically, in *Wells Fargo Bank, N.A. v. Stewart (In re Stewart)*,[2] the Fifth Circuit issued an opinion overturning a bankruptcy court injunction on the grounds that the bankruptcy court lacked jurisdiction to issue the injunction.[3]

In re Stewart involved the bankruptcy of Dorothy Stewart, an elderly widow. Wells Fargo Bank filed a proof of claim in Ms. Stewart's case alleging debts owed on a mortgage on Ms. Stewart's home. The proof of claim did not, however, provide full documentation to support the claim. Ms. Stewart hired a lawyer to aid her in determining the validity of Wells Fargo's claims. Wells Fargo was not cooperative in providing the information requested by Ms. Stewart, and provided only a list of charges by type, but without including the amount, date, or payee for the charges. Wells Fargo also failed to provide invoices or proofs of payment for certain third-party fees it was charging to Ms. Stewart. At a hearing, the Wells Fargo lawyers were unfamiliar with her case and could not provide additional information or documentation relating to the Wells Fargo claim. As the hearing progressed, "errors in billing became evident."

Wells Fargo's Errors

It took four months of research and two additional hearings for the bankruptcy court to finally "unravel Wells Fargo's accounting." Upon inspecting the full reconciliation of Ms. Stewart's mortgage account, the bankruptcy court determined that Well's Fargo's proof of claim "was rife with errors." The errors had resulted in a $10,000 overstatement on Wells Fargo's proof of claim. The bankruptcy court found that the errors in Wells Fargo's claims were "systematic" and attributed the errors to Wells Fargo's "highly automated, computerized loan-administration system." The bankruptcy court noted that few debtors challenge the accounting of their lenders, and as a result that lenders lack the necessary incentive to ensure the accuracy of their proofs of claim. Those errors "enlarge the debt of the estate, make reorganization more difficult for the debtor, and adversely impact upon the claims of the remaining creditors." The bankruptcy court further observed that the problem is compounded because under the Bankruptcy Code, proofs of claim must be treated as *prima facie* valid.

The Injunction

The bankruptcy court, perceiving this inaccuracy in Wells Fargo's process as "a threat to the integrity of the bankruptcy system," issued an injunction[4] ordering Wells Fargo:

> (1) to audit every proof of claim it has filed in this District in any case pending on or filed after April 13, 2007;
> (2) to provide a complete loan history on every account and to file that history with the appropriate court; and
> (3) to amend…proofs of claim already on file to comply with the principles established in this case and *Jones*.[5]

On appeal, the district court affirmed the bankruptcy court's decision.[6] The Fifth Circuit, however, vacated the injunction and dismissed the appeal as moot, holding that the bankruptcy court lacked authority to issue the injunction.

The Fifth Circuit found that the injunction was inappropriate because: (1) Ms. Stewart lacked standing to support the injunction; (2) the injunction did not "follow from the inherent power of the court to protect its jurisdiction and judgments and to control its docket"; and (3) the injunction was not a proper exercise of the "court's 'collateral' power to protect from abuse of process."

The Debtor Lacked Standing to Support the Injunction

Relying on *City of Los Angeles v. Lyons*,[7] the court stated that standing for an injunction requires that the petitioning party establish the existence of a real and immediate threat that is likely to cause injury to the petitioning party in the future. The court emphasized that Ms. Stewart was merely objecting to Wells Fargo's claim in her case and that the case before the bankruptcy court did not involve any claims on behalf of any other parties or classes. Because Ms. Stewart had not demonstrated that there was a likelihood that she would ever be harmed again by an incorrect proof of claim filed by Wells Fargo, Ms. Stewart lacked the necessary standing to support an injunction on her behalf.

The Bankruptcy Court's Inherent and Collateral Powers Did Not Support the Injunction

Because Ms. Stewart lacked standing, the court considered whether the bankruptcy court had authority to issue the injunction based on its inherent power to protect its jurisdiction and judgments and to control its docket. The court summarily dismissed this inherent power as the basis for the court's authority noting that "misdeeds in other cases can be addressed by the judges in those cases" and asserting that if the case-by-case process proved inadequate, "there remains the rulemaking authority."

The final source of authority addressed by the court was the "court's 'collateral' power to protect from abuse of process." The court quickly dispensed with this final potential source of authority noting that this collateral power was not a "distinct grant of authority" but rather "the inherent power of the court to do those things necessary to its discharge of judicial duty." The court noted that Ms. Stewart's injuries were remedied without the operation of the injunction and that the injunction really targeted Wells Fargo's conduct in other cases. The court found that because the injunction was aimed at Wells Fargo's actions in other cases, not just Ms. Stewart's case, and because there was no "pattern of conduct that flouts a judicial ruling in subsequent cases" that the injunction was not necessary to the discharge of the bankruptcy court's collateral power to protect from abuse of process.

[1] With apologies to our Cajun bankruptcy brethren.
[2] No. 09-30832, 2011 U.S. App. LEXIS 15029 (5th Cir. July 22, 2011).
[3] The bankruptcy court opinion is: *In re Stewart*, 391 B.R. 327 (Bankr. E.D. La. 2008).
[4] Ms. Stewart did not request the injunction and did not taken a position with regard to its validity. In a subsequent order at *In re Stewart*, No. 07-11113, 2008 Bankr. LEXIS 3226 (Bankr. E.D. La. Oct. 15, 2008), the bankruptcy court clarified that it had issued the injunction pursuant to its authority under 11 U.S.C. § 105 to take any action necessary to prevent an abuse of process.
[5] *In re Jones*, 366 B.R. 584 (Bankr. E.D. La. 2007).
[6] *In re Stewart*, No. 08-3225, 2009 U.S. Dist. LEXIS 53441 (E.D. La. June 10, 2009).
[7] 461 U.S. 95 (1983).

Not a Bright Line Rule

The court emphasized that it was not attempting to draw bright boundaries to define a court's power to correct abuses of its process. Rather, the court was simply holding that in this case the injunction "was outside that boundary" whatever it is.

In re Balas: Setting Precedent for Better or for Worse?

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On June 13, 2011, the United States Bankruptcy Court for the Central District of California ruled that the 1996 Federal Defense of Marriage Act ("DOMA") is unconstitutional and does not bar a lawfully married same-sex couple from filing a joint bankruptcy petition. *In re Balas*, 449 B.R. 567 (Bankr. C.D. Cal. 2011). Although noteworthy as the most recent episode of the controversial DOMA saga, *In re Balas* also raises unanswered questions for bankruptcy lawyers—and judges—all across the country.

Background: A Turn for the Worse

Same-sex marriage was legal in California for a short period of time. *In re Balas*, 449 B.R. at 570. Approximately 18,000 same-sex couples were wed in California before the November 2008 passage of Proposition 8 made same-sex marriage illegal again. *Id.* For at least one of these couples, life took a turn for the worse. Stricken by unemployment, bouts of illness, and periods of hospitalization, Gene Balas and Carlos Morales ("Debtors") filed a joint Chapter 13 petition on February 24, 2011. *Id.* Their petition for relief would give them time and breathing space to restructure and repay their debts, and to do so jointly. During their bankruptcy proceeding, the United States Trustee ("Trustee") brought a Motion to Dismiss pursuant to § 1307(c) of the Bankruptcy Code. *Id.* at 569. The Trustee argued that the case should be dismissed for cause on the grounds that Gene and Carlos were not in fact "spouses" within the definition of DOMA and, therefore, they could not file a joint bankruptcy petition under § 302(a) of the Bankruptcy Code. *Id.* In the alternative, the Trustee argued that the joint petition should at least be severed and re-filed as individual petitions to comply with DOMA. *Id.* at 571.

The court thus had to grapple with the issue of whether a same-sex couple, lawfully married in their state, could file a joint petition as "spouses" under § 302(a) of the Bankruptcy Code even though DOMA defines the term "spouse" for all purposes of federal law as "a person of the opposite sex who is a husband or a wife." 1 U.S.C. § 7 (2006). *In re Balas*, 449 B.R. at 569.

The Bankruptcy Code

Gene Balas and Carlos Morales filed their Chapter 13 bankruptcy petition jointly pursuant to § 302(a) of the Bankruptcy Code, which provides that any eligible individual and "such individual's spouse" may file jointly. 11 U.S.C. § 302(a) (2006). It was undisputed that both Gene and Carlos were eligible debtors—that is, able to file voluntary petitions for relief individually. *In re Balas*, 449 B.R. at 570.

The 1996 Defense of Marriage Act

The Defense of Marriage Act was passed by large majorities of both houses of Congress and signed into law by President Clinton on September 21, 1996. DOMA provides that, for all purposes of federal law, (1) "'marriage' means only a legal union between one man and one woman as husband and wife," and (2) "spouse" is to be defined as "a person of the opposite sex who is a husband or a wife." 1 U.S.C. § 7 (2006). Although uncontroversial at the time of its passage, DOMA has since become the subject of litigation and heated dispute. *In re Balas* represents the most recent chapter in what has become a national debate about the meaning of marriage and—more and more—the proper role of each of the three branches of government. Legal challenges to the constitutionality of DOMA have not yet been taken up by the Supreme Court. Recently, the Obama Administration announced its opinion that DOMA is unconstitutional and has even instructed Department of Justice officials not to defend the law if challenged in federal court.

The Motion to Dismiss

The court began by assessing the merits of the Trustee's motion to dismiss pursuant to §1307(c). *In re Balas*, 449 B.R. at 570. Section 1307(c) provides that the United States Trustee may dismiss a case for cause. 11 U.S.C. § 1307(c) (2006). Section 1307(c) gives a list of eleven example "causes" for dismissal, introducing the list with the term "including." *Id.* The court drew attention to the fact that the Trustee's motion to dismiss was not based on any of the eleven causes identified in § 1307(c). *In re Balas*, 449 B.R. at 571. The court then turned to an analysis of DOMA.

The Bankruptcy Court Weighs in on DOMA

The court's analysis in *In re Balas* dwelled less on bankruptcy law, and more on DOMA. Finding the text of DOMA clear and unambiguous, the court decided not to grapple with its interpretation or applicability but, rather, undertook a systematic assessment of the constitutionality of DOMA. First, the court noted that "[it] must begin its consideration of the issues with the presumption that a duly enacted act of Congress is constitutional." *Id.* at 572. However, citing a February 23, 2011 letter from Attorney General Eric Holder to Speaker of the House John Boehner, the court concluded that a heightened scrutiny review of DOMA was warranted because of DOMA's alleged classification based on sexual orientation. *Id.* at 574. The Debtors argued that DOMA violated their equal protection rights under the Fifth Amendment. *Id.* at 577. With heightened scrutiny comes as-applied rather than facial review of DOMA. *Id.* Therefore, the court had to determine whether dismissal of the Debtors' joint bankruptcy petition pursuant to DOMA advanced any "valid, defensible governmental interest." *Id.* at 575. The court found that none of the standard governmental interests identified with DOMA of (1) encouraging responsible procreating and childbearing, (2) defending or nurturing the institution of marriage, (3) defending traditional notions of morality, and (4) preserving scarce resources were met in this case. *Id.*

Next, the court reviewed DOMA under the rational basis test, again reviewing the four governmental interests posited as goals of DOMA from above. *Id.* at 578-579. The court held that those interests did not provide Congress with a rational basis for DOMA. *Id.*

The Court's Holding

Having determined that, in its view, DOMA failed both a heightened scrutiny and a rational basis review, the court held DOMA to be unconstitutional as applied to a lawfully-wed same-sex couple seeking to file a joint petition for bankruptcy relief under § 302(a) of the Bankruptcy Code. *Id.* at 579. As a result, the court denied the Trustee's motion to dismiss. *Id.* at 579-580.

With a Grain of Salt: Analysis and Application

In re Balas leaves unanswered questions for bankruptcy lawyers—and judges—all across the country. These include:

What to Make of the Motion to Dismiss? The court treated the examples of "for cause" motions to dismiss under § 1307(c) as an exclusive list. *See id.* at 570-571. This approach finds little support in the Bankruptcy Code and in case law interpreting this type of language, particularly since the list of eleven "for cause" motions to dismiss is introduced by the term "including—" and does not otherwise indicate that this is an exhaustive list. *See* 11 U.S.C. 1307(c) (2006). Nonetheless, the court treats it as such. Lawyers and judges should

question whether *In re Balas* has introduced a new—and overly strict—reading of the § 1307(c) motion to dismiss standard.

Anybody Heard of *Stern v. Marshall*? *Stern v. Marshall* rocked the world of bankruptcy law on June 23, 2011. *Stern v. Marshall*, 131 S. Ct. 2594 (2011). In *Stern*, the Supreme Court took away the power of bankruptcy judges to render final judgments on common law compulsory counterclaims. *See id.* at 2620. Although the full force of the Supreme Court's 5-4 holding is yet to be seen in practice, it is clear that the spirit of *Stern* is the intent to limit the power and reach of bankruptcy courts. *In re Balas* pre-dates *Stern* by ten days. However, had *Stern* come first, the bankruptcy court may have been more cautious about stepping out of its traditional realm of competence to deem DOMA an unconstitutional exercise of Congressional authority.

Is the Rational Basis Test Really that Hard to Satisfy? The court ruled that Congress had no rational basis for passing DOMA into law in 1996. *In re Balas*, 449 B.R. at 579. This comes as a surprise after the court's initial statement that "the court must begin its consideration of the issues with the presumption that a duly enacted act of Congress is constitutional." *Id.* at 572. That there can be no rational basis for preserving a three-thousand-year-old civil institution appears difficult to fathom. *See* Sherif Girgis, *What is Marriage?* 34 Harv. J.L. & Pub. Pol'y 245, 247 (2011). Furthermore, the court appeared to put undue weight on an informal letter from Eric Holder to John Boehner. While this letter is some evidence of the present administration's view that DOMA cannot withstand heightened scrutiny—it is, at best, only minimally persuasive. Lawyers and judges may wonder if the court's view of DOMA is subject to change when a new administration with a different view takes office.

A "Camelot" Moment? Joint filing of same-sex couples is only conceivable in states where same-sex marriage is (or was) legal. Thus, for the time being, *In re Balas* has limited import for bankruptcy practitioners outside of these states. Moreover, the unique fact scenario at issue in *In re Balas* (lawfully wed same-sex couples in a state where same-sex marriage is no longer legal) represents a "Camelot moment" not likely to be repeated.

Inadequate Support? The court cited only two cases to support the contention that violations of DOMA are not grounds for a motion to dismiss in a bankruptcy proceeding. *In re Balas*, 449 B.R. at 571-572. However, neither of these cases dealt with a Chapter 13 joint bankruptcy petition. *See id.* Instead, these cases involved motions to dismiss in Chapter 7 proceedings. *Id.* Motions to dismiss under these two chapters are governed by different sections of the Code, § 707(b) as opposed to § 1307(c), and significantly different in the standards they apply. To rely exclusively on precedent that shares neither fact nor law with the case at hand makes the court's argument that much less persuasive.

Too Early to Tell? The court's decision in *In re Balas* was appealed by the Department of Justice (and, notably, contrary to the internal policy of the Obama Administration). Additionally, *In re Somers* (448 B.R. 677 (Bankr. S.D.N.Y. 2011)), on which the court relies for the proposition that violations of DOMA are not adequate grounds for a dismissal "for cause," is currently on appeal. *In re Balas*, 449 B.R. at 572, FN2. Perhaps it is just too early to tell what the full weight and application will be.

For these six reasons, the court's opinion should be taken with a grain of salt, at least until time (and the pending appeals) run their course. *In re Balas* raises the unanswered questions addressed above and will leave bankruptcy lawyers—and judges—asking: is this precedent for better or for worse?

Bankruptcy Section Calendar of Events

Upcoming Events

Sept. 8-10, 2011: The FBA Annual Meeting and Convention will take place in Chicago at the Sheraton Chicago Hotel & Towers. As mentioned in the Chair's message above, the section will present a CLE at the convention, followed by a short business meeting and a reception for the Chicago bankruptcy judges on Friday afternoon. All section members are welcomed and encouraged to attend all these activities, as well as the various other CLE sessions, business meetings, and social events taking place over the course of the convention. The times for the section-specific events on Friday, September 9th are as follows:

11:15-12:30 p.m.—"Ponzi and Revenge," CLE with a discussion by a panel including: Irving Picard, Baker & Hoestetler, Douglas Kelley, Kelley, Wolter & Scott PA, Douglas Baird, Harry A. Bigelow Distinguished Service Professor of Law University of Chicago Law School, and Ronald R. Peterson, Jenner & Block.

12:30-12:45 p.m.—Section business meeting, including the presentation and selection of the new slate of officers and executive committee members and discussion of topics of interest with, and suggestions to, section leaders by section members.

4:00 – 5:30 p.m.—As also detailed in the Chair's message, the section reception honoring Chicago bankruptcy judges will be held at the Chi Bar, located on the lobby level of the Sheraton Chicago Hotel & Towers. Food and cocktails will be provided for section members and attending members of the judiciary. RSVP is requested.

Weekly Updates: Throughout this year, the section has provided weekly updates with cases of note by circuit, and has also provided updates on the status of and decisions rendered by the U.S. Supreme Court on cases arising in bankruptcy courts or that impact bankruptcy practice. The section will continue to provide these updates.

Please join the Bankruptcy Law Section of the Federal Bar Association for

A Reception Honoring the Chicago Bankruptcy Judges

In Conjunction with the 2011 Federal Bar Association Annual Meeting and Convention

Friday, September 9, 2011 • 4:00 – 5:30 p.m. at the Chi Bar, 301 East North Water Street, Chicago

The Chi Bar is located on the lobby level the Sheraton Chicago Hotel and Towers, where the convention will be held. If you have any questions or need additional information, please contact Sherwin Valerio at svalerio@fedbar.org.

This reception is complimentary for convention attendees and members of the Chicago bankruptcy bar.