# Bankruptcy Circuit Update

*Featuring cases from April 2016*

## First Circuit

***Wheaton v. Fessenden,***
**--- B.R.---, 2016 WL 1552389 (B.A.P. 1st Cir., April 14, 2016)**

The issue before the BAP was whether the Supreme Court's ruling in *Harris v. Viegelahn*, 135 S. Ct. 1829, 191 L. Ed. 2d 783 (2015), extends to a pre-confirmation dismissal of a chapter 13 case. The chapter 13 debtor's attorney obtained two fee award orders. The first order was entered prior to dismissal (the "First Fee Award") and the second order was entered after the case was dismissed (the "Second Fee Award"). After the Second Fee Award was granted, the bankruptcy court authorized the chapter 13 trustee to disburse the balance due on the First Fee Award and payment in full on the Second Fee Award from the funds paid to the trustee by the debtor. The chapter 13 trustee paid the balance due on the First Fee Award to the debtor's attorney, but refunded the balance of the funds held by him to the debtor by mistake. Efforts to recover the funds from the debtor were not successful.

The chapter 13 trustee filed his Final Report and Account without addressing the non-payment of the Second Fee Award. The debtor's attorney objected to the Final Report. In response, the chapter 13 trustee filed a Motion for Review of the fee applications previously approved by the bankruptcy court. Ultimately, the chapter 13 trustee and the debtor's attorney reached a settlement as to the outstanding amount due to the attorney. Based on the parties' stipulation as to the reduced amount, the bankruptcy court entered an order on the Motion for Review (the "Stipulation Order"). During a subsequent hearing, the parties and the bankruptcy court discussed whether under the *Harris* case, the chapter 13 trustee had a duty all along to return all of the funds he was holding to the debtor. The bankruptcy court ultimately decided that in light of the ruling in *Harris*, the Stipulation Order should be vacated (the "Vacating Order"), but the bankruptcy court did not order the debtor's attorney to return the payments he had already received from the chapter 13 trustee.

The BAP noted that a majority of courts have held that the *Harris* holding does not apply in a chapter 13 case that has been dismissed prior to confirmation (*Harris* involved conversion to chapter 7 and § 348). Instead, dismissal of a chapter 13 case is governed by §§ 349 and 1326(a). These sections revest property of the bankruptcy estate in the debtor upon dismissal and require the chapter 13 trustee to return those funds to the debtor if the case is dismissed prior to confirmation. However, § 1326(a) also states that allowed § 503(b) expenses must be paid prior to the refund to the debtor. Accordingly, the debtor's attorney was entitled to payment of the First and Second Fee Awards from the funds held by the chapter 13 Trustee. As a result, the BAP reversed the Vacating Order and remanded the case for the entry of an order consistent with the opinion.

***In re Lorenzo,***
**--- F.3d ---, 2016 WL 1275015 (1st Circuit, April 1, 2016) (per curiam)**

Scotiabank objected to the debtor's Chapter 13 plan, but failed to attend the confirmation hearing. The bankruptcy court sustained the debtor's objection to Scotiabank's claim at the confirmation hearing, denied its amended claim and confirmed the plan. The First Circuit quoted the Puerto Rico local rules which clearly provide that a creditor that objects to confirmation of a plan shall attend the confirmation hearing or risk the court overruling the objection for failure to prosecute the same. The First Circuit also adopted the reasoning of the BAP and summarily affirmed the decision. Further, although the First Circuit denied the debtor's request for sanctions under Federal Rule of Appellate Procedure 38, the court "warn[ed] Scotiabank and its counsel that some its arguments are frivolous, that all are without merit, and that its brief to this Court is unacceptable."

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## Second Circuit

***Vanguard Prods. Corp. v. Kim Citrin, Stephen James Curley, Dymax Corp. (In re Indicon, Inc.),***
**2016 WL 1295666 (April 4, 2016)**

The Second Circuit affirmed the district court's judgment affirming the bankruptcy court's order granting a letter motion filed by Joseph Tesoriere ("Tesoriere") to dismiss the adversary proceeding filed by Vanguard Products Corporation ("Vanguard") for lack of subject matter jurisdiction.

The debtor in this case, Indicon, Inc. ("Indicon") filed for bankruptcy in 2004 without informing Vanguard, who was Indicon's landlord, or listing Vanguard as a creditor. Vanguard did not learn of Indicon's bankruptcy until after the reorganization plan was confirmed; Vanguard subsequently successfully moved to reopen the bankruptcy case and obtain discovery in 2010. Vanguard then brought an adversary proceeding in the bankruptcy court against Indicon and its former principal, counsel, and financial advisors (including Tesoriere) alleging breach of its lease agreement and fraud, including fraud on the bankruptcy court. The bankruptcy court entered a default judgment against Indicon and granted Vanguard an administrative expense for damages for the breach of the lease agreement in addition to attorneys' fees and costs. The

default judgment determined that Vanguard's claim was not discharged by the bankruptcy. As for the claims against the remaining defendants, the bankruptcy court granted Tesoriere's motion to dismiss for lack of subject matter jurisdiction and *sua sponte* dismissed claims against the remaining defendants as well. The district court affirmed, and Vanguard appealed.

The Second Circuit began its analysis by noting that bankruptcy courts are courts of limited jurisdiction that may only hear proceedings "arising under title 11, or arising in or related to cases under title 11." 28 U.S.C. § 1334. The Second Circuit stated that this limitation may not be bypassed solely because a related proceeding may have some impact on a bankruptcy case; instead, the determinative question is whether the claim at issue derives from the bankruptcy itself or would necessarily be resolved in the claims allowance process. Here, Vanguard sought damages, including punitive damages, against the non-debtor defendants for breaches of fiduciary duty, fraudulent transfers, and violations of the Connecticut Unfair Trade Practices Act in order to satisfy the default judgment that Vanguard had against Indicon. However, the bankruptcy proceeding was over and Indicon had already been dissolved; moreover, Vanguard conceded that it did not seek to reopen the bankruptcy case to redistribute the proceeds that were paid through the plan. As such, if Vanguard were successful in its adversary proceeding, the recovery would go not to the bankruptcy estate but to Vanguard itself, and therefore the resolution of the claims would have no effect on the debtor's estate. The Second Circuit thus affirmed that the bankruptcy court lacked subject matter jurisdiction over Vanguard's claims.

***Fletcher v. Ball (In re Soundview Elite Ltd.),***
**2016 WL 1459533 (April 14, 2016)**

The Second Circuit affirmed the district court's judgment denying a motion for reconsideration and affirming the bankruptcy court order denying the motion filed by Alphonse Fletcher, Jr. ("Fletcher") to remove the chapter 11 trustee.

The Second Circuit began its analysis by noting that it reviews a bankruptcy court's denial of a motion to remove the trustee under 11 U.S.C. § 324(a) for abuse of discretion, which occurs when a court bases its ruling on an erroneous view of the law or a clearly erroneous assessment of the evidence. Under Bankruptcy Code section 324(a), the bankruptcy court may remove a trustee for cause, which traditionally involves finding fraud and actual injury to a debtor's interests.

The Second Circuit found that Fletcher did not show fraud or actual injury to debtor interests. Before the bankruptcy court approved her appointment, the trustee gave notice that her law firm may have represented and may continue to represent "parties actually or potentially adverse" to the debtors but stated that it would not do so in any matters relating to the debtors or their chapter 11 cases. Fletcher did not allege that the trustee knew of any specific conflict that she failed to disclose despite her knowledge of both the conflict and her responsibility to disclose it. The Second Circuit also found that Fletcher's assertion that the trustee's law firm had previously reported, in unrelated proceedings, working for parties that were not mentioned in its disclosure did not show that the trustee knowingly failed to report a current, relevant conflict. Moreover, Fletcher also did not show or allege any actual injury to the debtors' interests.

Therefore, the Second Circuit held that the bankruptcy court did not abuse its discretion in denying the motion to remove the trustee.

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## Third Circuit

***In re World Imports Ltd.*, 2016 WL 1580730 (3rd Cir. April 20, 2016)**

The Third Circuit reversed and remanded the Eastern District of Pennsylvania's decision that a non-vessel common carrier did not hold a valid maritime lien for certain freight and related charges associated with goods for which the carrier provided transportations services prior to the petition date. Specifically, the Court found that the carrier did not waive its lien upon delivery because the evidence failed to demonstrate that the carrier's delivery of the goods was "unconditional." Finally, the Court held that the carrier's valid lien on goods previously delivered would attach to any cargo that later entered the carrier's possession.

***In re D'Angelo* 2016 WL 1594606 (3rd Cir. April 21, 2016)**

The Third Circuit affirmed the Eastern District of Pennsylvania's decision dismissing a mortgagor's attempt to avoid as a preferential transfer an equitable lien against its property. The primary issue was whether the Bankruptcy Court correctly found that a state court equitable lien order operated to effect a transfer of a property interest to the lender. The Third Circuit agreed with the lower courts that the equitable lien given to the lender consisted of nothing more than a right of subrogation to the rights of the prior lienholder and therefore did not constitute an assignment of an interest in the property.

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**Fourth Circuit**

***Anderson v. Hancock*,**
**2016 WL 1660178 (4th Cir. April 27, 2016)**:

On April 27, 2016, the Fourth Circuit affirmed in part and reversed in part the decision of the U.S. District Court for the Eastern District of North Carolina concerning the rights of debtors to modify a secured claim under § 1322(b).

In September 2011, the joint-debtors purchased a home financed by a 30-year mortgage, with a fixed interest rate of 5.0% that would increase to 7.0% upon default. Prepetition, in April 2013, the debtors failed to make their regular monthly payment, and the secured creditors later informed the debtors that the 7.0% default interest rate would be imposed. In late August 2013, the secured creditors, having received no payments, initiated foreclosure proceedings. In mid-September 2013, the debtors filed a chapter 13 bankruptcy petition.

The debtors' chapter 13 plan proposed to cure the prepetition arrears at an interest rate of 5.0% and to reinstate the 5.0% interest rate on post-petition payments. The secured creditors objected, requesting application of the 7.0% default interest rate for both the prepetition arrears and the post-petition payments. The bankruptcy court sustained the secured creditors' objection based on § 1322(b)(2), which prevents modification of creditor's rights that are secured by a debtor's principal residence.

The debtors then appealed to the district court, which affirmed the bankruptcy court's ruling that the post-petition payments must be made at the 7.0% default interest rate. The district court, however, ruled that for the period of time between the petition date and the plan's effective date—about 3 months—the debtors may cure those payments at an interest rate of 5.0%, based on whether and when the loan was accelerated or decelerated. The debtors appealed to the Fourth Circuit.

In examining the plain language and legislative history of § 1322(b), the Fourth Circuit ruled that accepting the debtors' argument that the 5.0% interest rate applied would be an impermissible modification of the promissory note's terms pursuant to § 1322(b)(2). The debtors' post-petition payments must reflect the contractual, default interest rate. The Fourth Circuit affirmed the decision in part, but reversed the district court's holding that the 5.0% interest rate applied for payments between the petition date and plan effective date.

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**Fifth Circuit**

***U.S. v. Chaker,***
**--- F.3d ---, 2016 WL 1552408 (5th Cir. Apr. 14, 2016).**

The Fifth Circuit affirmed Darren Chaker's bench trial conviction for bankruptcy fraud arising from Chaker's failure to disclose rental income arising from his property. On appeal, Chaker raised constructive amendment concerns, claiming the court had convicted him on charges broader than those set forth in his indictment. First, Chaker argued the court convicted him on a scheme different than that alleged in the indictment, specifically because its factual findings included facts and events occurring prior to the March 2007 scheme alleged. The Fifth Circuit disagreed, pointing to the court's factual findings directly addressing the scheme set forth in the indictment. The Court reasoned that the inclusion of pre-March 2007 facts was relevant to the lower court's determination of Chaker's intent and its rejection of his "innocent misrepresentation" defense. Chaker also argued his indictment failed to notify him that his use of certain corporate entities to mask his ownership of the rental property would be relevant at trial. Pointing to the indictment's discussion of those entities and the government's pre-trial filing stating it intended to use such evidence, the Fifth Circuit rejected that notion.

Second, Chaker argued constructive amendment because the court purportedly convicted him of bankruptcy fraud on five elements that applied, not to bankruptcy fraud, but to the charge of false declaration under penalty of perjury. The Fifth Circuit disagreed, highlighting the district court's specific findings relating to the proper elements of the crime of bankruptcy fraud. Finally, Chaker claimed constructive amendment based on the court's supposed failure to find evidence on the specific misrepresentations set forth in the indictment. The Fifth Circuit again summarily rejected this argument, pointing to the factual findings relating to the indictment's allegations.

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***In re BNP Petroleum Corp.*,**
**--- F. Appx. ---, 2016 WL 1295103 (5th Cir. Apr. 1, 2016) (per curiam).**

The Debtors were two of Paul Black's business enterprises which were involved in litigation with Toby Shor and his business entities (collectively, "Shor"). During the bankruptcy case, Shor moved to lift the stay to pursue claims in arbitration against Black and related entities stemming from Shor's investments in Black's entities. The arbitration panel found in favor of

Shor and awarded Shor approximately $30 million. The chapter 7 trustee (the "Trustee") filed an adversary proceeding against Black and Shor claiming that both defendants benefited from improper transfers from the Debtors. Shor filed a motion in Texas state court for turnover on certain assets owned by Black in order to collect on the $30 million judgment.

In the adversary proceeding, Black negotiated a settlement with the Trustee (the "Black Settlement"). After the Black Settlement was executed, but before approval by the bankruptcy court, the Trustee reached a competing agreement with Shor (the "Shor Agreement"). In the Shor Agreement, Shor would purchase the Trustee's claims against Black in exchange for cash. The Trustee and Shor filed a joint motion in the bankruptcy court for approval of the Shor Agreement. After finding the Shor Agreement was in the best interest of the estate and was not the product of collusion, the bankruptcy court approved the Shor Agreement. Black filed what was treated as Rule 60 Motion to reconsider the approval of the Shor Agreement, specifically arguing that Shor had committed a fraud on the court through the state court turnover motions. The bankruptcy denied Black's Rule 60 Motion, which Black appealed along with the Order Approving the Shor Agreement. The district court affirmed the Approval Order and the denial of Black's Rule 60 Motion.

Section 363(m) patently protects, from later modification on appeal, an authorized sale where the purchaser acted in good faith and the sale was not stayed pending appeal. *In re Gilchrist*, 891 F.2d 559, 560 (5th Cir. 1990). Therefore, the Fifth Circuit had to determine whether the Shor Agreement was entered into in good faith. In finding that it was, the Fifth Circuit noted that the Trustee was under a duty to entertain all serious offers and the Shor Agreement augmented the estate by providing guaranteed value and ending controversies that diminish the estate through administrative expenses. Further, the Fifth Circuit concluded that nothing in Black Settlement precluded the Trustee from considering other offers because the Black Settlement was expressly subject to final approval by the bankruptcy court. Moreover, the Fifth Circuit found that none of Shor's actions complained of in Black's Rule 60 Motion rose to the level of "fraud on the court." Such fraud encapsulates only the most egregious misconduct, like bribery or fabrication of evidence, whereas here, Shor merely engaged in post-settlement collection efforts.

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## Sixth Circuit

***In re Mathis*,**
**--- B.R. ----, 2016 WL 1569329 (Bankr. E.D. Mich. Apr. 18, 2016)**

The Bankruptcy Court holds that a chapter 7 trustee cannot sue a debtor for damages caused by the debtor to his or her bankruptcy estate for failing to comply with the debtor's duties under § 521(a)(1), (3) and (4) of the Bankruptcy Code. The debtor in the case filed a *pro se* chapter 13 initially that was eventually converted to chapter 7. Given the level of cooperation from the debtor, or rather, the lack thereof, the chapter 7 trustee filed an adversary complaint with several causes of action. Among the grounds for relief was an allegation that the debtor had breached the three specific statutory duties under § 521 previously referenced. However, the Bankruptcy Court held that no implied right to sue for a breach of those duties exists in favor of a trustee. Rather, the Bankruptcy Code provides other remedies for sanctioning such conduct.

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## Seventh Circuit

***In re Blanchard*,**
**2016 WL 1459568 (7th Cir. April 14, 2016)**

On April 14, 2016, the Seventh Circuit affirmed the decision of the bankruptcy court, holding that under Wisconsin law a lender can properly attach a mortgage lien to a vendor's interest in a land contract, and that such a lien is properly recorded in the Wisconsin land records rather than as a UCC filing under Article 9. Specifically, the debtors had entered into a land contract to sell certain real estate. Thereafter, the debtors purported to mortgage the land, and the mortgage was recorded against the land. The debtors later filed for Chapter 7 bankruptcy and the trustee tried to use his strong-arm powers under 11 U.S.C. § 544(a)(3), so that he could step in line ahead of the bank's mortgage on the theory that the debtors had no more interest in the land at the time of the mortgage, having already sold their interest in the real property under the land contract and therefore retaining only a personal property interest in the contract itself (and which was not subject to a mortgage or any other lien). The Seventh Circuit disagreed, holding that the debtors retained an interest in the real property even after executing the land contract because under Wisconsin law, the vendor in a land contract arrangement retains title to the land.

For this same reason, the court also held that such a mortgage is properly recorded in Wisconsin's land records rather than as a UCC filing under UCC Article 9.

***In re Collazo,***
**2016 WL 1358459 (7th Cir. April 5, 2016)**

On April 5, 2016, the Seventh Circuit affirmed in part and reversed in part the decisions of the bankruptcy and district courts, holding that plaintiffs in adversary proceedings cannot prevent discharge of debts based on fraud where their cause of action is time-barred. Specifically, the debtor had been a real estate investor who borrowed money from the plaintiffs for the purpose of investment. Plaintiffs were promised that they would be paid within a certain time frame after certain condos were sold. The condos were later sold without plaintiffs being repaid, and plaintiffs were aware of this fact more or less contemporaneous with its occurrence. The debtor gave plaintiffs an explanation for the delay at the time, but the Seventh Circuit ruled that a "reasonable investor in [plaintiffs'] position would have investigated much earlier, and sued much earlier" in light of the non-payment. Therefore, those fraud claims were time-barred and properly discharged in bankruptcy. However, with respect to separate fraud claims based on the debtor's improperly transferring title to certain condos without so much as a peep, rather than based on any affirmative statements by debtor, the Seventh Circuit noted that the United States Supreme Court is considering that very issue now (whether there can be a fraud without a fraudulent statement), and such claims could be resuscitated by the Supreme Court's ruling. Therefore, those state law fraud claims were remanded to the bankruptcy court, subject to either the parties' consent to proceed before the bankruptcy court or submission to the district court of proposed findings of fact and conclusions of law, in keeping with *Wellness Int'l Network, Ltd. v. Sharif*, 135 S. Ct. 1932, 1939 (2015).

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**<u>Ninth Circuit</u>**

***Scheer v. The State Bar of California (In re Scheer),***
**2016 WL 1459217 (9th Cir. Feb. 14, 2006)**

The issue before the Ninth Circuit was whether a debt in the form of a pre-petition arbitration award in favor of the debtor-attorney's former client constituted a debt that was non-dischargeable under Section 523(a)(7) of the Bankruptcy Code. An arbitrator found that the debtor-attorney had to refund a fee she received in advance of services rendered (modifying a mortgage), as well as the arbitration filing fee, to her former client. Section 523(a)(7) contemplates a "fine, penalty, or forfeiture" which is "payable to and for the benefit of a

governmental unit." The court rejected application of *Kelly v. Robinson*, 479 U.S. 36 (1986) holding a criminal restitution non-dischargeable under Section 523(a)(7), and distinguished *State Bar of California v. Findley*, 593 F.3d 1048 (9th Cir. 2010) holding a fee assessed for the cost of a disciplinary proceeding intended to "promote rehabilitation and to protect the public" as opposed to compensation, and held that the arbitration award was not within the scope of Section 523(a)(7). In so holding, the court explained that the debt was "purely compensatory" and "not disciplinary." Slip Op. at 10. The court further explained that

> [t]o categorize the fee dispute in this case as non-dischargeable simply because the State expresses a strong regulatory interest in a particular industry would render any attorney-client fee dispute non-dischargeable. Moreover, the State's logic would extend to fee disputes in any closely regulated industry—doctors, dentists, chiropractors, barbers, locksmiths, real estate agents, acupuncturists, tattoo artists, and so on. We require clearer language in section 523(a)(7) before we can endorse such an incremental yet horizonless approach—otherwise, we will end up boiling a frog that Congress never intended to leave the lily pad.

Slip Op. at 10. Thus, the court focused on, and applied, the plain language of the statute.

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***First S. Nat'l Bank v. Sunnyslope Housing Ltd. P'ship,***
**—F.3d—, 2016 WL 1392318 (9th Cir. 2016)**

In *First S. Nat'l Bank v. Sunnyslope Housing Ltd. P'ship*, the Ninth Circuit reversed the district court's affirmance of the bankruptcy court's confirmation of a chapter 11 plan and held that creditor First Southern's secured claim in an apartment complex should be valued under §506(a) without reference to restrictive covenants which required the property to be used as affordable housing.

The Panel first held that the appeal was not equitably moot and that First Southern's failure to seek a stay was not fatal to the appeal because it had made efforts to obtain a stay from the district court and bankruptcy court. The Court found that the transactions were not too complex to unwind, and although the new equity investor might be unable to recover its investment and would incur tax penalties if confirmation were reversed, it was "not the kind of innocent third party the doctrine of equitable mootness is intended to protect."

The Circuit acknowledged that *Assoc. Commercial Corp. v. Rash*, 520 U.S. 953 (1997) requires a replacement value for cramdown purposes but determined that the reference in §506(a) to the "proposed disposition or use" merely identifies the alternatives of surrender and retention and does not refer to the specific way in which the Debtor will use the property. The Court also noted that unlike in *Rash*, the replacement value would be substantially less than the foreclosure value because foreclosure would have the effect of terminating the restrictive covenants. The Court reasoned that replacement value is typically higher than foreclosure value and that *Rash* requires a replacement value in order to compensate the creditor for bearing the "double risks" of potential future default and depreciating collateral.

Judge Paez dissented and criticized the majority as imposing a "hypothetical foreclosure method" instead of a replacement value. Judge Paez wrote that *Rash* requires valuing the property "from the debtor's perspective in light of the 'economic benefit for the debtor derived from the collateral'" and because Debtor proposed to use the property as affordable housing—the only permissible use of the property given that the restrictive covenants remained in place—the property should be valued in light of that use. Judge Paez argued that the majority's methodology contravened the Supreme Court's direction that replacement value should measure the cost to obtain similar property and that no willing buyer would purchase similar property for a price that did not reflect the restrictive covenants.

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## 11th Circuit

***Rosenberg v. DVI Receivables XIV, LLC,***
**— F.3d —, 2016 WL 1392642 (11th Cir. April 8, 2016).**

The appellees originally filed an involuntary bankruptcy petition against the appellant. The bankruptcy court dismissed the involuntary petition in 2009. The appellant subsequently filed an adversary complaint against the appellees to determine damages under 11 U.S.C. § 303(i), which allows a putative debtor to recover certain damages caused by the filing of an improper involuntary petition. The appellees moved to withdraw the reference with respect to the appellant's § 303(i)(2) claims for actual and punitive damages. The district court granted this request, leaving only the appellant's claims for attorney's fees and costs with the bankruptcy court.

The case proceeded to a jury trial, which resulted in a verdict awarding the appellant $1.12 million in compensatory damages and $5 million in punitive damages. Twenty-eight days later, the appellees filed a motion for judgment as a matter of law, arguing that the evidence did not support the damages award. Although the appellees' motion was timely under Rule 50(b) of the Federal Rules of Civil Procedure, which allows 28 days for the filing of a judgment as a matter of law, it was untimely under Rule 9015(c) of the Federal Rules of Bankruptcy Procedure, which allows only 14 days for the filing of a judgment as a matter of law. Accordingly, the appellant moved to strike the appellees' motion.

After concluding that the Federal Rules of Civil Procedure controlled and that the evidence did not in fact support the verdict, the district court granted the appellees' motion and entered an amended judgment holding the appellees liable for only $360,000. Both parties appealed.

The U.S. Court of Appeals for the Eleventh Circuit held that the Federal Rules of Bankruptcy Procedure govern all cases "arising under" the Bankruptcy Code, even if tried in a federal district court. Accordingly, the circuit court concluded that the district court was bound to apply Rule 9015(c)'s 14-day deadline, rather than Rule 50(b)'s 28-day deadline. As such, the circuit court reversed the district court's order granting the appellees' motion for a judgment as a matter of law and remanded the case for a reinstatement of the jury's verdict.

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