Bankruptcy Circuit Update

Featuring cases from April 2017

Special Announcement
Group Section Conference Call to Discuss Significant Cases

This month our writers Circuit Writers and Section Leaders will be convening our next section-wide conference call on **Friday, May 26, 2017, at 3:30 E.S.T./12:30 P.S.T**. to present and discuss notable cases from the past few months of the summaries. Volunteers will be summarizing significant or interesting cases. The presenters will be open for questions and lead discussion of key points. We hope you will join us for this call. The call-in information is: **dial in 866-690-2070 – code 787-594-2077**. If any section–members, whether or not you are a Circuit Writer, would like to volunteer to discuss a significant case or recent bankruptcy development, please e-mail us at csullivan@diamondmccarthy.com.

First Circuit

***In re Curran (Privitera v. Curran),* Case No. 169006, 2017 WL 1405211(1st Cir., April 20, 2017)**

In *Privitera v. Curran (In re Curran*), the First Circuit Court of Appeals on an appeal of a motion to dismiss ruled whether a list comprising of the debtor's items intended as collateral for a loan was a false statement under 11 U.S.C. § 523(a)(2)(B). In the case, plaintiff agreed to loan money to the debtor and the debtor provided plaintiff with a list of property that belonged to him. This list was then attached to the loan agreement and labeled "List of Collateral." Neither the plaintiff nor the debtor took steps to perfect plaintiff's security interest. The debtor defaulted on the loan, and plaintiff obtained a default judgment. Plaintiff learned that title to certain properties on the List of Collateral was not held by the debtor. After the debtor filed for bankruptcy, plaintiff brought an adversary proceeding seeking an order declaring the debt non-dischargeable, primarily under 11 U.S.C. § 523(a)(2)(B). The bankruptcy court dismissed the complaint and the BAP affirmed.

At the Circuit level, the parties asked the Court to resolve a circuit split and determine whether the phrase "statement…respecting the debtor's…financial condition," as used in § 523(a)(2)(B) was to be read narrowly to refer only to those documents that speak directly of the debtor's financial condition or broadly to those documents that reference a single asset or liability. The Circuit however declined to opine on the split and instead affirmed on the principles of pleading and materiality. The Court explained that the plaintiff failed to plausibly allege that the List of Collateral was materially false. Material falsity within the purview of § 523(a)(2)(B) requires a plaintiff to "plausibly allege that the statement misrepresented the kind of information that would normally affect the decision to grant credit and thus portrayed a substantially untruthful picture of the debtor's financial condition." The Court stated that plaintiff's complaint failed because she did not claim that the substance of the List of Collateral was untrue, nor did she claim that the debtor made any affirmative misrepresentations about the nature of his interest in the enumerated items. The failure to speak becomes a misrepresentation by omission only if the context requires

the debtor to speak. Here, the complaint contained no facts indicating that the debtor was required to tell plaintiff that certain property was encumbered.

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Second Circuit

***Brown Media Corp. v. K&L Gates*, *LLP*, Docket No. 15-4185, 854 F.3d 150 (2d Cir., April 14, 2017)**

The Second Circuit vacated the judgment of the district court holding that res judicata barred the plaintiffs' claims for breach of fiduciary duty, tortious interference, and common law fraud against the defendant law firm K&L Gates and its attorneys who represented the plaintiffs in connection with their proposed purchase of the assets of debtor Brown Publishing in bankruptcy.

K&L Gates ("K&L"), a large international law firm, and two of its former partners (collectively, "the defendants"), represented Brown Publishing Company, Brown Media Holdings Company, and their affiliates (collectively, "Brown Publishing") in Brown Publishing's Chapter 11 bankruptcy. Plaintiff Roy Brown ("Brown") was the former Chief Executive Officer, as well as a former shareholder, manager, and director of Brown Publishing. Brown and other Brown Publishing insiders owned and controlled plaintiff Brown Media Corporation ("Brown Media" and, together with Brown, "the plaintiffs"), which they formed to purchase Brown Publishing's assets in a bankruptcy auction. Before entering bankruptcy, Brown Publishing was a closely-held corporation controlled by Brown, his brother, their parents, and Brown Publishing's former general counsel (collectively, the "Managers").

By March 2009, Brown Publishing was on the verge of defaulting on a loan, and K&L advised the Managers that a sale of Brown Publishing's assets in bankruptcy was the best way to retain control of the company. In June 2009, K&L notified certain Managers that the firm was interested in representing Brown Publishing in its bankruptcy proceeding. K&L, however, did not seek or obtain a waiver or consent from the Managers to do so. One month later, Brown Publishing retained K&L as counsel.

In August 2009, K&L and one of the Managers began preparing a "'stalking horse" asset purchase agreement (the "APA"). K&L also allegedly continued to serve as the Managers' counsel, despite having been retained by Brown Publishing. In addition to preparing the APA, K&L advised the Managers on how to maximize the chances that a bankruptcy court would approve their bid at a bankruptcy sale. K&L also advised the Managers with respect to forming Brown Media (the company that would make the stalking horse bid), and assisted the Managers in their effort to convince Brown Publishing's lenders to finance the Managers' purchase. With

the help of K&L, the Managers obtained a funding commitment through Guggenheim Partners to support their purchase offer.

Shortly before Brown Publishing filed for bankruptcy, K&L urged the Managers and Brown Media to obtain new counsel. On K&L's recommendation, the plaintiffs hired Richard Levy ("Levy"), a former partner of one of the K&L attorneys. By the time Levy was hired, however, Brown Media had been formed and much of the APA had been drafted.

In April 2010, Brown Publishing filed for Chapter 11 bankruptcy. As part of the bankruptcy court's approval of K&L as Brown Publishing's counsel, the firm submitted a disclosure statement which did not reveal K&L's prior representation of the Managers or the extent of its relationship with members of the PNC Bank Group, a rival bidder for Brown Publishing's assets. After the bankruptcy filing, Brown Publishing received a credit bid from the PNC Bank Group. That bid, however, was rejected as inferior to the Managers' stalking horse bid, because the Managers' bid involved an agreement to assume several critical leases for real estate owned by CRJ Investments ("CRJ"), an affiliate of Brown Publishing. The property subject to those leases housed all of Brown Publishing's manufacturing operations and a substantial majority of its profit generating operations.

Thus, in May 2010, Brown Publishing, advised by K&L, executed the APA and sought the bankruptcy court's approval of the sale of its assets to the Managers through Brown Media. The bankruptcy court approved the Managers' bid and also approved procedures for the eventual sale of Brown Publishing's assets should an auction become necessary. Although the Managers had retained Levy to represent them, K&L continued to treat the Managers like clients, advising them on how to answer questions at a creditors meeting and discussing bankruptcy issues with some of the Managers, all without Levy present.

Huntington Bank was also a creditor of Brown Publishing and a sometime client of K&L. In June 2010, Huntington Bank filed a foreclosure action against CRJ in an Ohio state court, a strategy intended to reduce the value of Brown Media's assumption of the CRJ leases, thereby undermining the plaintiffs' bid for Brown Publishing's assets. The foreclosure action violated the bankruptcy stay, and Brown Publishing's general counsel directed K&L to promptly file a motion to enforce the automatic stay.

Through its representation of the plaintiffs, K&L understood that the leases owned by CRJ were a critical component of the Managers' strategy and the funding of their bid. K&L, however, allegedly deliberately delayed filing the stay motion until after the final review of the bids for Brown Publishing's assets so that the PNC Bank Group would be the successful bidder. In light of these events, K&L declared the PNC Bank Group's bid to be the superior bid, which necessitated an auction of Brown Publishing's assets. Because Brown Media's financing had collapsed due to the foreclosure action, the PNC Bank Group was successful in acquiring Brown Publishing's assets. Following the auction, K&L successfully moved in the Huntington Bank foreclosure action to enforce the automatic bankruptcy stay. By then, however, it was too late for the plaintiffs to salvage their bid.

The plaintiffs subsequently asserted the following causes of action against the defendants: (1) breach of fiduciary duty based on the defendants' (a) failure to secure a waiver of the conflict of interest presented by their dual representation of the Managers and Brown Publishing, (b) failure to disclose their relationship with members of the PNC Bank Group, and (c) use of confidential information gleaned from K&L's representation of the plaintiffs to manipulate the bidding process in favor of the PNC Bank Group; (2) tortious interference with prospective economic advantage based on the defendants' interference with the relationship between the Managers and Brown Publishing; and (3) common law fraud based on the defendants' breach of their duty to disclose potential conflicts of interest.

The defendants moved to dismiss the complaint under Federal Rule 12(b)(6) for failure to state a claim, arguing that the plaintiffs' claims were barred by res judicata and, in particular, by the preclusive effect of three final orders of the bankruptcy court: (1) the "Sale Procedures Order," which approved procedures for the eventual sale of Brown Publishing's assets; (2) the "Sale Approval Order," which authorized the sale of Brown Publishing's assets, and (3) the "Confirmation Order," which confirmed Brown Publishing's liquidation plan. The district court granted the defendants' motion on res judicata grounds, noting that the parties disputed only one prong of the res judicata analysis: "whether the causes of action were the same, and if not, whether the claims asserted by the Plaintiffs in this action could have been brought in the prior proceeding."

The district court determined that the plaintiffs' action was "a thinly disguised" collateral attack on the bankruptcy orders. The court reasoned that the plaintiffs sought to challenge the result of the § 363 sale by placing themselves in the same position as if they had been the successful bidders of Brown Publishing's assets. The court explained that, ultimately, the plaintiffs' action was "so inextricably linked" to the underlying bankruptcy proceeding that the relief sought by the plaintiffs would require the court "to effectively overrule" the bankruptcy court's orders. According to the district court, any policy interest in allowing the plaintiffs to proceed with their action was "outweighed by the longstanding policy favoring the finality of sale orders issued by bankruptcy courts." The plaintiffs appealed this judgment.

The Second Circuit began its analysis by stating that a determination of whether res judicata bars a subsequent action requires a court to consider whether 1) the prior decision was a final judgment on the merits, 2) the litigants were the same parties, 3) the prior court was of competent jurisdiction, and 4) the causes of action were the same. In the bankruptcy context, a res judicata analysis also requires consideration of whether an independent judgment in a separate proceeding would impair, destroy, challenge, or invalidate the enforceability or effectiveness of the reorganization plan. The Second Circuit noted that this can be an "awkward fit" because bankruptcy proceedings are not like typical lawsuits (where one party brings an action against another), but instead provide a forum for multiple parties—debtors, creditors, bidders, and others—to determine common issues. Accordingly, instead of examining whether a subsequent lawsuit asserts claims that could have been included as part of a previous lawsuit, in the bankruptcy context courts have assessed whether a new action seeks to bring claims that could have been raised and litigated within the scope of the bankruptcy proceeding.

The Second Circuit noted that the plaintiffs focused the vast majority of their allegations on K&L's allegedly conflict-ridden decision to delay filing a motion in the foreclosure action to enforce the automatic stay. Accordingly, in the Second Circuit's view, the complaint alleged misconduct only on the part of the defendants, not the other parties to the auction. Thus, because the plaintiffs were not alleging collusion among the defendants and the PNC Bank Group (through Huntington Bank's foreclosure action) or Brown Publishing, it was not incumbent on the plaintiffs to challenge in the bankruptcy court the "good faith purchaser" status of the PNC Bank Group or, more generally, the "intrinsic fairness" of the bankruptcy sale on grounds of collusion.

The Second Circuit also noted that even if plaintiffs had informed the bankruptcy court of the issues, then the most likely outcome would have been K&L's removal as counsel to Brown Publishing, which would not have provided the plaintiffs a fair forum in which to fully litigate its claims, which sought to remedy not simply the fact of a conflict but the defendants' effective interference with the plaintiffs attempt to acquire the debtor's assets. The Second Circuit reasoned that although consideration of the defendants' potential conflict of interest may have prompted the bankruptcy court to examine some of the facts necessary to support the present claims, the factual overlap would have been limited by the proper framing of each claim.

On appeal, the defendants asserted that bankruptcy courts have "arising in" jurisdiction over malpractice and similar claims against a debtor's retained professionals that occur during a bankruptcy because they are inseparable from the bankruptcy context. The Second Circuit was not persuaded by this argument, finding that just because a bankruptcy court need not abstain from exercising jurisdiction over a claim does not mean that failing to ask the bankruptcy court to exercise its "arising in" jurisdiction necessarily precludes a plaintiff's future claim. Accordingly, the Second Circuit disagreed with the district court that the plaintiffs could have, and should have, raised their present claims in the bankruptcy proceeding.

The Second Circuit also rejected the district court's further conclusion that the "practical effect of the relief sought" by the plaintiffs would "call into question the integrity" of the bankruptcy court's orders. The Second Circuit stated that under the circumstances, it was not persuaded that, had the plaintiffs' asserted their present claims in bankruptcy court or sought to litigate the issues necessary to those claims, the bankruptcy court would have structured a different disposition in the liquidation plan. This was because the plaintiffs' allegations were not aimed at the parties subject to the bankruptcy court orders—the PNC Bank Group, the creditors, and Brown Publishing—but at K&L and two of its former partners. Because the factual allegations in the complaint did not implicate the parties to the bankruptcy proceedings, the Second Circuit held that the plaintiffs' failure to raise their claims against the defendants in bankruptcy court did not "almost certainly affect" bankruptcy orders that pertained only to the parties participating in the bankruptcy proceedings. The Second Circuit therefore vacated the district court's decision to dismiss the case on the basis of res judicata and remanded the case to the district court.

In re Tronox, Inc. (Tronox Inc. v. Kerr-McGee Corp.), **Docket No. 16-343, 2017 WL 1403001 (2d Cir., April 20, 2017)**

The Second Circuit dismissed for lack of jurisdiction an appeal of the district court's judgment granting the motion of Defendant Kerr-McGee Corporation, a non-debtor affiliate of certain debtors with significant toxic tort liabilities, to dismiss with prejudice the claims asserted by the plaintiffs in Pennsylvania state court because their claims were derivative and duplicative of claims that were part of a $5.15 billion bankruptcy settlement and therefore barred by the post-settlement, permanent anti-suit injunction.

This case centers on more than 4,300 individuals (the "Avoca Plaintiffs") who alleged significant injuries from the operation of a wood-treatment plant in Avoca, Pennsylvania (the "Avoca Plant") between 1956 and 1996. They originally brought their toxic-tort claims in Pennsylvania state court (the "PA State Action") against several entities including Kerr-McGee Corporation ("New Kerr-McGee"), but their suits were stayed when two of those entities, Tronox LLC and Tronox Worldwide LLC (f/k/a Kerr-McGee Chemical and Kerr-McGee Operating Corp., respectively), the owners/operators of the Avoca Plant (the "Debtors"), filed for bankruptcy in the Southern District of New York. The PA State Action remained stayed at the time of this appeal.

The bankruptcy proceeding involved a series of corporate transformations that ultimately yielded New Kerr-McGee. After the spinoff, New Kerr-McGee maintained control of the more lucrative oil and gas businesses and left the Debtors with the immense environmental and tort liabilities arising from the previous operation of the Avoca Plant. These transactions were, as the bankruptcy court concluded, essentially fraudulent conveyances designed to place assets beyond the reach of the Debtors' creditors.

In the course of the bankruptcy proceeding, the Debtors instituted an adversary proceeding against New Kerr-McGee for fraudulent conveyance to recover assets that would satisfy the debtors' liabilities. Ultimately, New Kerr-McGee settled with the Debtors for over $5 billion; of that sum, more than $600 million was designated for beneficiaries of a tort claims trust which required the distribution of a specified share (12%) of any recovery from the adversary proceeding to participants, which included the Avoca Plaintiffs. New Kerr-McGee sought peace with that payment and required that the district court tasked with approving the bankruptcy settlement issue an injunction barring the litigation of claims that were derivative or duplicative of the Debtors' claims against New Kerr-McGee (the "Injunction"). The district court approved the settlement and the Injunction; because no judgment had ever issued, the bankruptcy judge's liability findings never became final and binding.

After the district court approved the settlement and issued the Injunction, the Avoca Plaintiffs sought to revive their toxic-tort claims in Pennsylvania state court, again naming New Kerr-McGee as a defendant. The Avoca Plaintiffs did not, however, alter their state-court complaint to allege direct claims against New Kerr-McGee to hold it responsible for its own alleged wrongdoing or discuss the effect the Injunction may have had on the state law claims. Instead, they advanced indirect alter-ego and veil-piercing theories to hold New Kerr-McGee responsible for the conduct of the Debtors; such theories were based in part on the non-binding findings of

the bankruptcy court prior to the settlement of the adversary proceeding. New Kerr-McGee moved for an order enforcing the Injunction and for sanctions, asserting that the Injunction foreclosed claims that arose from liabilities derived from or through the Debtors that were also generalized and common to all creditors.

The district court concluded that (1) the Avoca Plaintiffs' claims were extinguished by the settlement of the adversary proceeding; and (2) even if they were not, the claims were barred by the Injunction. Without imposing sanctions or finding contempt, the district court ordered the Avoca Plaintiffs to dismiss with prejudice their state-court complaints. The Avoca Plaintiffs appealed and sought a stay pending appeal, which the Second Circuit granted.

The Avoca Plaintiffs asserted several bases for appellate jurisdiction, including 28 U.S.C. §§ 1291 and 1292(a)(1), all of which the Second Circuit found unpersuasive. First, the Second Circuit held that the district court's order was not "final" for purposes of 28 U.S.C. § 1291, because it neither found contempt nor imposed sanctions. The Second Circuit began its analysis of this issue by noting that it is well-established that a final order is one that conclusively determines the rights of the parties to the litigation, leaving nothing for the district court to do but execute the order. Here, the district court's order was issued in the context of a pending contempt motion but made no contempt finding nor an assessment of sanctions. Accordingly, the Second Circuit held that the order was not "final" as contemplated by § 1291. The Second Circuit clarified that the district court proceedings concerning compliance with the Injunction would not reach final adjudication until such time as the contempt issue is fully resolved, which would occur if the Avoca Plaintiffs refused to comply and were sanctioned.

Second, the Second Circuit concluded that it lacked jurisdiction under § 1292(a)(1) because the district court properly construed (and neither modified nor continued) the Injunction. Section 1292(a)(1) allows interlocutory appeals from orders "granting, continuing, modifying, refusing or dissolving injunctions, or refusing to dissolve or modify injunctions." Here, the Second Circuit performed a de novo review of the order and the Injunction and determined that the district court's interpretation of the Injunction was proper, in that the district court did not modify its terms through the order.

The primary question the Second Circuit addressed in this context was whether the Avoca Plaintiffs' claims were in fact derivative claims within a bankruptcy court's jurisdiction, i.e., whether the claims were property of the Debtors' estates. Derivative claims in the bankruptcy context are those that arise from harm done to the estate and that seek relief against third parties that pushed the debtor into bankruptcy. Here, the Second Circuit looked to several recent cases in the Second Circuit in its attempt to distinguish between derivative from non-derivative claims, specifically *St. Paul*, *Manville III*, *JPMorgan*, and *Madoff.* Ultimately, the Second Circuit concluded that the causes of action here qualified as "general" claims based largely on the Avoca Plaintiffs' concession that while they no longer intended to bring claims against the released Debtors, their sole claims against New Kerr-McGee were nevertheless premised indirectly on the liability of those Debtors. In other words, the harm the Avoca Plaintiffs alleged to have suffered at the hands of the Debtors was specific to them (and would therefore not qualify as "general" claims), but the harm the Avoca Plaintiffs alleged to have suffered at the hands of New Kerr-McGee was the same harm general to all of the Debtors' creditors. The Second Circuit noted

that the critical distinction between the underlying tort claim against the Debtors and the alter-ego claim against New Kerr-McGee is that establishing the former would benefit only the Avoca Plaintiffs as individual creditors, whereas establishing the latter—that New Kerr-McGee is the alter ego of the relevant Debtors and should therefore be charged with all its liabilities—would benefit all creditors of the Debtors generally. The Second Circuit found that the Avoca Plaintiffs' tactics proved this point; the Avoca Plaintiffs sought to use the bankruptcy judge's findings against New Kerr-McGee in the adversary proceeding—which involved generalized claims for fraudulent conveyance—in their state action.

After a close review of the text of the Injunction, the Second Circuit held that the district court acted within its discretion when it ordered the Avoca Plaintiffs to dismiss their claims with prejudice and did not modify the Injunction in doing so. The Second Circuit therefore dismissed the appeal for lack of jurisdiction.

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Third Circuit

***In re Lansaw (Lansaw v. Zokaites),* No. 166-1867, 853 F.3d 657 (3d Cir., April 10, 2017)**

This case arises out of an adversary proceeding on appealed by defendant Frank Zokaites. The bankruptcy court found, and the district court affirmed, that Zokaites had committed several willful violations of the automatic stay arising from Garth and Deborah Lansaws' Chapter 7 bankruptcy petition.

The Lansaws operated a daycare in space leased from Zokaites, but eventually the Lansaws entered into a new lease with a different landlord. Angered by the new lease, Zokaites filed a Notice of Distraint, claiming a lien for unpaid rent on the Lansaws' personal property. Shortly thereafter, the Lansaws filed for bankruptcy, thus triggering the automatic stay. Despite being notified of the bankruptcy petition, Zokaites entered the daycare without permission and attempted to collect on his debt in three separate instances. During these attempts, Zokaites pushed Mrs. Lansaw against a wall in her office, took photographs of the Lansaws' personal property while children were present, padlocked and chained the doors, and threatened legal action against Lansaws' new landlord, among other actions.

The bankruptcy court determined that Zokaites's actions constituted a willful violation the automatic stay and awarded the Lansaws emotional distress damages as well as punitive damages under Bankruptcy Code § 362(k)(1). The district court affirmed the awards, and Zokaites appealed.

In a matter of first impression, Third Circuit Court of Appeals addressed whether emotional distress damages can be awarded as "actual damages" under § 362(k)(1). The Court affirmed that § 362(k)(1) authorizes the award of emotional distress damages and that the Lansaws presented sufficient evidence to support such an award. Additionally, the Court held that the Lansaws were properly awarded punitive damages.

(1) *Whether the term "actual damages" under § 362(k)(1) authorizes recovery for emotional distress damages*

The Court first determined whether the term "actual damages" under § 362(k)(1) authorizes recovery for emotional distress. The statute provides, with an exception not applicable in this case, that "an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." 11 U.S.C. § 362(k)(1).

There is a split of authority on whether emotional distress damages are authorized under § 362(k)(1). Three circuits—the Eleventh, Ninth, and First— have expressly concluded that emotional distress damages are available for willful violations of the automatic stay under the statute. Two circuits—the Fifth and Seventh—have left open the possibility that in some circumstances emotional distress damages may be available. One district court—the Northern District of Ohio— has rejected the notion that emotional distress damages are available as "actual damages" under the statute.

The Third Circuit examined the conflicting authority, first referencing *United States v. Harchar*, 331 B.R. 720, 732 (N.D. Ohio 2005), the case that found emotional distress damages are unavailable under § 362(k)(1). *Harchar* found the statute to be ambiguous, relying on the fact that § 362(k)(1) was enacted six years after other automatic stay provisions were introduced in 1978, and that prior to the statute, contempt was the accepted mechanism for stay violations. Based on this history and Congress's failure to expressly reference emotional harms in § 362(k)(1), the court in *Harchar* concluded that when § 362(k)(1) was enacted, Congress was not concerned with emotional harms, "but with providing explicit statutory authorization for the only previously available remedy for a stay violation: Contempt." The *Harchar* court did find that the automatic stay was intended to protect against psychological harm, but it found that the provisions authorizing punitive damages and attorney's fees sufficiently addressed this.

The Court then reviewed *Aiello v. Providian Fin. Corp.*, 239 F.3d 876, 880 (7th Cir. 2001), which left open the possibility for emotional distress damages. *Aiello* reasoned that the automatic stay's protection is of a financial character and not for protection of "peace of mind," and there is no indication that Congress meant to change that when enacting § 362(k)(1). Also, nothing prohibited a debtor from bringing a suit under state tort law for emotional damages. However, the court "theorized" that considerations of judicial economy might permit an award for emotional distress under § 362(k)(1) where the plaintiff is already seeking damages for financial injury. Because no financial injury was alleged in *Aiello*, the Court found that plaintiff was not entitled to emotional distress damages using § 362(k)(1).

Lastly, the Court examined *Dawson v. Washington Mut. Bank, F.A., (In re Dawson)*, 390 F.3d 1139, 1148 (9th Cir. 2004). *Dawson* concluded that "pecuniary loss is not required in order to claim emotional distress damages" *Id.* at 1149. The court in *Dawson* looked at the legislative history behind the automatic stay provision. Based on a House Report for the Bankruptcy Reform Act of 1978, the court emphasized that Congress enacted the automatic stay not only to provide creditors financial protection, but also to provide "the debtor a *breathing spell* from his creditors. It stops all collection efforts, *all harassment*, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or *simply to be relieved of the financial pressures* that drove him into bankruptcy." (emphasis added by the Third Circuit). Additionally, *Dawson* noted Congress's concern with creditor collection tactics, which can be harassing and abusive.

Ultimately, the Third Circuit Court of Appeals adopted the holding and reasoning in *Dawson* as the correct approach. The Court examined the 1978 House Report and concluded that the automatic stay protects both financial and non-financial interests. As such, the Court reasoned that "it is only logical that Congress would intend to include damages resulting from that harm when it introduced 'actual damages' [in § 362(k)(1)] as the enforcement mechanism six years later." Therefore, the Court held that "actual damages" under § 362(k)(1) includes damages for emotional distress resulting from a willful violation of the automatic stay. The Court did not decide whether financial injury is necessary for recovery for emotional distress because the Lansaws had suffered financial injuries in the form of attorney's fees from when they sought to enjoin further violations of the stay.

(2) *What evidence is sufficient to support an award of emotional distress damages*

Next, the Court determined whether the Lansaws provided sufficient evidence to support their award of emotional distress damages. The Lansaws had only provided their own testimony of what Zokaites had done to willfully violate the automatic stay. Zokaites argued that medical documentation or expert medical testimony was necessary to corroborate the Lansaws' testimony. The Court held that the evidence necessary to demonstrate actual emotional harm, as required under the statute, will likely vary from cases to case. "But, at least where the evidence also shows that the stay violations were patently egregious, a plaintiff's credible testimony that the violations did in fact cause emotional distress is sufficient to support an award of damages." The Court affirmed the bankruptcy court's findings that the Lansaws presented sufficient evidence because their testimony was credible and Zokaites's stay violations "were so egregious that a reasonable person could be expected to suffer some emotional harm." Additionally, it found that the award of $7,500 for emotional distress that was based awards in similar cases "was neither unreasonable nor unduly speculative."

(3) *Whether the Bankruptcy Court erred in awarding the Lanslaws punitive damages*

Lastly, the Court upheld the bankruptcy court's punitive damages award. Zokaites argued that a principal purpose of a punitive damages award is to deter future misconduct, and there was nothing to deter since he had not contacted the Lanslaws in the years since the stay violations. However, the Court found that the egregiousness of Zokaites's violations and his attempts to downplay them at trial rendered punitive damages appropriate.

Additionally, the Court concluded that the $40,000 punitive damages award comported with due process. In so concluding, the court considered three guideposts (1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the punitive damages awarded; and (3) the difference between the punitive damages awarded and the civil penalties authorized or imposed in comparable cases. The Court found that Zokaites's repeated stay violations were sufficiently reprehensible to support the award. The 4-1 ratio between the punitive damages award and the actual damages award was in line with other awards deemed acceptable by the Supreme Court, and although $40,000 was higher than the other awards examined by the bankruptcy court, the Court found such award was still not so excessive as to be unconstitutional.

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Ninth Circuit

***In re Windscheffel (Windscheffel v. Montebello Unified School Dist.),* Bk. No.: 2:15-bk-19933-SK, BAP No. CC-16-1393-FLKu, 2017 WL 1371294 (9th Cir. BAP April 3, 2017),**

The BAP affirmed the bankruptcy court's dismissal of the dismissal of the debtor's chapter 11 case on bad faith grounds, rejecting the debtor's argument that the bankruptcy court committed reversible error in relying on judicially-created bad faith tests and not the factors set forth in § 1112(b)(4). The basis for dismissal was a state court judgment finding that the debtor converted over $400,000 in public school funds and commingled or mismanaged funds the state and federal governments granted to the school district for which the debtor's company operated after-school programs. The debtor appealed the decision but, unable to post a bond, he filed a chapter 11 case. Besides the judgment debt in excess of $2 million, the debtor listed only two other creditors with claims totaling $500.00. The bankruptcy court granted the school district's motion to dismiss on bad faith grounds, arguing the filing was done solely to avoid collection efforts without having to post a bond. The school district also argued that the debtor's amended chapter 11 plan was an improper attempt to avoid paying punitive damages, interest and attorney's fees as the proposed payout approximated the judgment without those additional awards. The bankruptcy court's decision analyzed factors set forth in case including from the Ninth Circuit in Marsch v. Marsch (In re Marsch), 36 F.3d 825 (9th Cir. 1994). The BAP rejected the contention by the debtor, who conceded that the factors set forth in § 1112(b)(4) were not exhaustive, that the bankruptcy court committed reversible error in applying other factors in determining "cause" warranting dismissal exceed the authority granted by Congress. The BAP specifically noted that there were multiple

tests setting forth applicable factors, and the bankruptcy court did not abuse its discretion in selecting the factors relevant to the facts before it.

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***In re Salamon (Mastan v. Salamon)*, No. 15-60031, 2017 WL 1404194 (9th Cir. April 20, 2017)**

In *In re Salamon*, the Ninth Circuit affirmed the BAP's decision to affirm the bankruptcy court's order disallowing the claim of creditor Mastan and held that a junior creditor whose lien is extinguished by foreclosure does not have a claim against the estate solely by virtue of §1111(b).

The Debtor originally purchased real property from David Behrend subject to two liens. Debtor executed a $1,030,000 wrap-around mortgage in favor of Behrend and a second note in the amount $325,000. The two notes were secured by third and fourth position liens. Behrend later filed a Chapter 11 in which Mastan was appointed trustee. The Debtor subsequently filed her own Chapter 11. Mastan filed a secured proof of claim on behalf of the Behrend estate for the two notes.

Debtor stipulated to stay relief with the most senior lienholder. The property was sold at a foreclosure sale for $1,275,500 which was sufficient to pay the balance of the first three liens and part of the fourth. Mastan then filed an amended claim for the unsecured balance of the fourth position note and Debtor objected. The bankruptcy court disallowed the claim and held that the property was no longer property of the estate upon foreclosure and that California's anti-deficiency provision applied. The BAP affirmed.

The Ninth Circuit held that regardless of the fact a lien existed on the petition date, the plain language of §1111(b) requires a lien to exist at the time the claim is challenged under §502. The Circuit noted that this result left Mastan in the same position as he was outside of bankruptcy. The foreclosure extinguished the junior liens and left Mastan without recourse to pursue deficiency judgments against Salamon.

***In re Dingley (Dingley v. Yellow Logistics)*, Case No. 14-60055, 852 F.3d 1143 (9th Cir. 2017)**

In *In re Dingley*, the Ninth Circuit affirmed, on a different basis, the BAP's decision to reverse the bankruptcy order awarding sanctions for violations of the automatic stay. The Circuit held that creditors Yellow Logistics, LLC and Yellow Express, LLC (together "Yellow") did not violate the stay by continuing state court civil contempt proceedings because such proceedings are exempted from the automatic stay under §362(b)(4).

In 2011, Yellow sued Dingley alleging state law claims involving improper towing, storage, and sale of a semi-truck and trailer belonging to Yellow. Dingley failed to appear for a deposition and was sanctioned by the court. After Dingley failed to pay the sanctions, Yellow initiated civil contempt proceedings and Dingley filed a Chapter 7 petition. The state court took the matter off calendar but asked for briefing on the effect of the bankruptcy. Yellow filed a supplemental brief in the state court and Debtor responded by filing a motion for sanctions in the bankruptcy court.

The bankruptcy court sanctioned Yellow in the amount of $1,500 and Yellow appealed. The BAP reversed and held that under *David v. Hooker*, 560 F.2d 412 (9th Cir. 1977), civil contempt proceedings are not automatically stayed unless they turn on the determination or collection of an underlying debt or are a ploy to harass the Debtor.

The Ninth Circuit affirmed on a different basis and noted that one year after *Hooker* was decided, the Bankruptcy Code was enacted with nearly thirty exceptions to the automatic stay, including §364(b)(4) which excepts actions by a government unit to enforce such governmental unit's police and regulatory power. Under Ninth Circuit precedent, a proceeding is exempt under §362(b)(4) if the government action either relates primarily to the government's pecuniary interest or is intended to effectuate public policy.

The Circuit held that under *In re Berg*, 230 F.3d 1165 (9th Cir. 2000) civil contempt proceedings to deter litigation misconduct are exempted under §362(b)(4) because the purpose of such litigation sanctions is to "effectuate public policy [in deterring unprofessional conduct in litigation."

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