

Bankruptcy Circuit Update

Featuring cases from August 2017

First Circuit

United Surety & Indemnity Co. v. Munoz (In re Pedro Lopez Munoz), No. 16-9007, 866 F.3d 487 (1st Cir. Aug. 9, 2017)

In this case, the First Circuit considered an appeal from a bankruptcy court's decision under 11 U.S.C. section 1104(a), to deny a creditor's motion to appoint a trustee for the bankruptcy estate to replace the debtor-in-possession. The debtor Pedro Lopez Munoz ("Lopez") owned 100% of the shares of a company HSGC, which owned a gas station. Lopez personally also owned a gas station (the "Mayaguez station"). Both stations were leased and HSGC and Lopez received rental payments on their respective stations. Approximately four months before Lopez filed a petition under chapter 11, he transferred his interest in the Mayaguez station and the lease to HSGC. That same day, he also transferred his shares in HSGC by "donat[ing]" them to a trust. Lopez was the sole beneficiary of the trust and his children were named substitute beneficiaries. One of Lopez's creditors United Surety and Indemnity Company ("USIC") filed a motion to appoint a chapter 11 trustee.

After holding an evidentiary hearing, the bankruptcy court denied USIC's motion and the Bankruptcy Appellate Panel affirmed. USIC then appealed to the First Circuit. On appeal, USIC first contended that the bankruptcy court erred as a matter of law by presuming that no fraud under the meaning of section 1104(a)(1) occurred because of the absence of evidence that the transfers in question had a material effect on the value of the bankruptcy estate. The Circuit stated that contrary to USIC's assertions, the bankruptcy court took account of the transfers lack of materially adverse impact on the bankruptcy estate under the totality of circumstances. The lack of monetary loss to the estate was not the sole factor the bankruptcy court considered. USIC also argued that under the ruling of *Huskey International Electronics, Inc. v. Ritz*, 136 S.Ct. 1581 (2016), USIC only needed to prove that Lopez had "engaged in a transfer to a close relative, a secrete transfer, a transfer of title without transfer of possession or grossly inadequate consideration, regardless of whether the scheme involved a false representation." The Circuit dismissed USIC's argument and stated that *Husky* concerned fraud under 11 U.S.C. section 523(a)(2)(A) and not section 1104(a)(1). Moreover, a finding of fraud rests on a totality of circumstances, and the court here considered all the evidence adduced at a two-day hearing.

USIC also argued that Lopez's statement that he transferred the Mayaguez station to HSGC to "protect his assets from aggressive collection actions of just one unsecured creditor" is the intent required to show fraud for the purposes of section 1104(a)(1). The Circuit, however, held that because USIC had not made this argument to the bankruptcy court, the argument was waived. Additionally, the Circuit stated that USIC had failed to identify any authority supporting the proposition that Lopez's claimed motivation with respect to actions taken in response to collection efforts of one creditor for the benefit of other creditors automatically made transfers fraudulent for the purposes of section 1104. USIC further argued that the bankruptcy court erred in finding that the appointment of a trustee would not be in the best interests of the creditors

because a turnover cause of action existed with respect to the lease payments made to HSGC, and Lopez due to his ties with HSGC would not bring this action. The Circuit noted however that the bankruptcy court found that based on the testimony presented, there was no surplus owed by HSGC to the estate for the period HSGC operated the Mayaguez gas station since HSGC paid the debtor's mortgage and assumed operating expenses of the lease. For the foregoing reasons, and many more detailed in the Circuit's opinion, the Circuit affirmed the bankruptcy court's order.

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Second Circuit

Netflix, Inc. v. Relativity Media, LLC (In re Relativity Fashion, LLC), No. 16-3282, 2017 WL 3601238 (2d Cir. Aug. 22, 2017)

In a dispute centered on the right to stream certain films prior to their theatrical release dates, the Second Circuit affirmed the judgment of the district court affirming the bankruptcy court order authorizing the motion to enforce the chapter 11 plan filed by Relativity Media, LLC ("Relativity") and denying the motion to compel arbitration filed by Netflix, Inc. ("Netflix").

On appeal, Netflix argued that its 2010 licensing agreement with Relativity (the "License Agreement"), as amended by two contracts assigning royalty payments to third-party lenders (the "Notices of Assignment," or "NOAs"), authorized it to distribute two of Relativity's films through its video-streaming service before those films were released in theaters. Specifically, Netflix challenged (1) the bankruptcy court's jurisdiction over the post-confirmation dispute and the NOAs' arbitration clauses and (2) the bankruptcy court's judgment enjoining Netflix from streaming the films prior to their theatrical release based upon (a) res judicata, (b) judicial estoppel, and (c) the terms of the License Agreement and the NOAs.

The Second Circuit first addressed Netflix's argument that the bankruptcy court lacked jurisdiction to adjudicate this dispute, regardless of whether it was core or non-core, because it primarily involved an alleged post-confirmation contractual breach. The Second Circuit noted, however, that reorganization plans may explicitly provide for post-confirmation jurisdiction, as Relativity's did. In such circumstances, core status depends partly on the degree to which the proceeding at issue is independent of the reorganization, which turns on whether the proceeding is unique to or uniquely affected by the bankruptcy proceedings or affects a core bankruptcy function, such as administering the estate's property.

Because of the significant impact the parties' dispute had on the bankruptcy proceedings, the Second Circuit held that this was a core proceeding. During Relativity's bankruptcy, Netflix filed a proof of claim and objected to the proposed plan of reorganization, arguing that projected

delays in the theatrical release dates of Relativity's films would create corresponding delays in Netflix's right to stream those films at a later date. Relativity's confirmed plan implicitly incorporated Netflix's understanding of the importance of pre-streaming theatrical release, providing relief to certain creditors through anticipated revenues from the films' theatrical releases. Moreover, testimony at a post-confirmation hearing established that Netflix's proposed pre-release streaming of films would effectively destroy anticipated theatrical revenue streams. As such, the Second Circuit held that this dispute was a "core" proceeding over which the bankruptcy court was entitled to exercise jurisdiction because Netflix's post-confirmation change of position would have both had a significant impact on the administration of the estate and undercut the creditor relief provided by the plan.

After quickly disposing of Netflix's argument that the bankruptcy court lacked statutory authority to authorize partial assumption of an executory contract (by noting that Relativity assumed the agreements in their entirety during the bankruptcy), the Second Circuit turned to Netflix's constitutional challenge to the bankruptcy court's exercise of jurisdiction in light of *Stern v. Marshall*, 564 U.S. 462 (2011). In *Stern*, the Supreme Court held that bankruptcy court judges may not enter final judgments on claims and counterclaims which are exclusively based on legal rights guaranteed by state law. However, the Second Circuit noted that the holding in *Stern* was narrow and firmly rooted in the facts of that case; accordingly, the *Stern* holding did not address the circumstance presented in this dispute, where the bankruptcy court acted only to enjoin Netflix from advancing arguments inconsistent with the objections it raised in Relativity's bankruptcy proceedings. The Second Circuit found that enjoining litigation that interferes with bankruptcy proceedings was sufficiently distinguishable from the holding in *Stern*, which related to the entry of a final tort judgment.

The Second Circuit then addressed the denial of Netflix's motion to compel arbitration, noting that a bankruptcy court may retain jurisdiction over a core proceeding in spite of a mandatory arbitration provision if it concludes that any underlying purpose of the Bankruptcy Code would be adversely affected by enforcing the arbitration clause. In the context of this analysis, relevant considerations include (i) the centralized resolution of "pure bankruptcy issues," (ii) the need to protect creditors and reorganizing debtors from piecemeal litigation, and (iii) the undisputed power of a bankruptcy court to enforce its own orders. Here, the Second Circuit found that the bankruptcy court had properly weighed the competing bankruptcy interests and arbitration interests and concluded that granting Netflix's motion to compel arbitration would permit a "collateral attack" on the factual findings and distributions of property underlying the confirmed plan, which would cause "key" aspects of the plan to collapse. Based on the hearing testimony regarding the dramatic reduction in box office revenues if Netflix were permitted to stream the films prior to their theatrical release, the Second Circuit held that the bankruptcy court's denial of the motion to compel arbitration was not clearly erroneous.

Finally, the Second Circuit turned to Netflix's argument that, based on the NOAs, the bankruptcy and district courts erred in concluding that Netflix was contractually obliged to defer its streaming of Relativity's films until their release dates. Under the NOAs, Netflix's payment for Relativity's films is "due and payable in full" either when such film is delivered to Netflix or twelve months after the film's theatrical release; however, the NOA's further provide that if such date has not occurred on or before June 17, 2016, then that date shall serve as the date upon

which payment is due. Netflix argued that, based this language, Relativity's failure to release the films in theaters on or before June 17, 2016, made that date the applicable "Start Date" for streaming.

However, the Second Circuit reasoned that the NOAs cannot be analyzed separately from the License Agreement to which they pertain. Section 5.6 of that agreement states that Netflix "shall . . . enter into all agreements reasonably requested by Relativity or any financial institution . . . provided such agreements are of a nature which are customarily entered into in connection with comparable credit facilities and shall not result in any additional material obligations on Netflix's part." Relying on this provision, Relativity and its creditor CIT Bank, N.A., asked Netflix to adjust the NOAs' anticipated "Start Dates" to reflect anticipated delays in the films' theatrical releases. In fact, the plain language of section 5.6 of the License Agreement obligated Netflix to do so if such accommodation was customary in the industry and did not impose additional material obligations on Netflix.

The Second Circuit noted that there was no clear error in the bankruptcy court's crediting of testimony from industry professionals that it was customary for content distributors such as Netflix to consent to extensions of time to accommodate delays in a film's theatrical release date. Further, the Second Circuit noted that Netflix's own witness averred that it was a "material requirement" of the parties' agreement that "the films provided must be first run, theatrically released films." Indeed, as the bankruptcy court observed, the royalties due from Netflix under the License Agreement were not even calculable absent theatrical release because that agreement provided for Netflix's license fee to be based on domestic box office receipts. Thus, because the requested accommodation imposed no additional material obligation on Netflix, the Second Circuit held that bankruptcy court correctly concluded that Netflix was contractually obliged to accede to the request to delay its own streaming start date until the films at issue were theatrically released.

Accordingly, the Second Circuit affirmed the judgment of the bankruptcy court enjoining Netflix from asserting a right to stream Relativity's films prior to their theatrical release dates.

3rd Circuit Case Submissions

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Third Circuit

Antone Corp v. Haggen Holdings, LLC (In re Haggen Holdings, LLC, et al.), No. 15-11874, Civ. No. 15-1136 GMS (3d Cir. Aug. 30, 2017) Unreported

In *Haggen*, the district court affirmed longstanding Third Circuit precedent that profit sharing provisions in executory contracts and unexpired leases are unenforceable anti-assignment provisions under Bankruptcy Code section 365(f)(1). Antone Corp., a landlord, appealed a

bankruptcy court order approving the assignment of its commercial property lease with the debtor, a grocery store chain. Specifically, Antone argued that the bankruptcy court erred in refusing to enforce a profit sharing provision contained in the lease upon assignment. The profit sharing provision entitled Antone to 50% of all net profits realized by debtor upon assignment.

The bankruptcy court found that the profit sharing provision was a “very much akin, if not identical” to other profit sharing provisions previously held to be unenforceable anti-assignment provisions under the plain language of § 365(f)(1) of the Bankruptcy Code.

Undeterred, Antone argued that the bankruptcy court erred by failing to consider evidence of the unique facts and circumstances of the lease. Specifically, Antone contended that unlike other profit sharing provisions found to be unenforceable, its profit sharing provision was a “bargained for exchange” and “economically interdependent” with other lease provisions because Antone agreed to forbear from collecting market value increases in exchange for the profit sharing provision.

On appeal, the district court confirmed that Antone’s profit sharing provision was an unenforceable anti-assignment provision under Bankruptcy Code § 365(f)(1). The court endorsed longstanding Third Circuit precedent that section 365(f) was designed to prevent anti-alienation or other clauses in leases and executory contracts from defeating the debtor’s ability to realize the full value of its assets. Further, the district court emphasized that not only does § 365(f)(1) concern provisions that explicitly prohibit assignment, it also specifically forbids clauses that restrict or condition assignment. As a result, the district court found that, although the profit sharing provision did not prohibit assignment, it clearly conditioned assignment upon the payment of profits.

Further, the district court found that the bankruptcy court did not need to analyze evidence of the facts and circumstances leading to the profit sharing provision. The court found that the cases relied on by Antone involving rights of first refusal and cross-default provisions were distinguishable. Instead the court was persuaded by the reasoning in *Angelone v. Great Atl. & Pac. Tea Co., Inc.*, 2016 WL 6084012, at *6 (Bankr. S.D.N.Y. Oct. 17, 2016) (“*A&P*”) which similarly held that a 50% profit sharing provision was an unenforceable condition on assignment. Like Antone, the landlord in *A & P* argued that its negotiated profit sharing provision was entitled to enforcement because of the parties bargained-for exchange resolving litigation over the debtor’s prior defaults. In its decision, the *A & P* court reasoned that Congress had “already struck a careful balance between the rights of the parties’ by enacting Section 365(f).” *Id.* at *6. Thus, the “landlord’s interest must yield to the public policy interest of maximizing the value of all creditors notwithstanding the parties’ carefully negotiated bargain.” *Id.* Accordingly, the bankruptcy court was not required to balance the equities or otherwise analyze the facts and circumstances given the unenforceability of the profit sharing provision under § 365(f)(1) as a matter of law.

Weinberg v. Scott E. Kaplan, LLC, No. 16-4145
(3d. Cir. Aug. 21, 2017) Unreported

In *Weinberg*, two individual plaintiffs appealed the district court's order dismissing their malpractice lawsuit against the defendant, their former chapter 11 bankruptcy attorney. The plaintiffs brought their state law malpractice action as a separate lawsuit over one year after the bankruptcy court confirmed the plaintiffs' chapter 11 plan.

The plaintiffs' malpractice claim singled out two alleged incidences of malpractice during the course of the bankruptcy case. The first stemmed from the defendant's allegedly deficient response to a creditor's motion for relief from the automatic stay to continue a foreclosure action, which the bankruptcy court granted for the incorrect property. The plaintiffs alleged that the defendant did not move for reconsideration in a timely manner and his dilatory response harmed the estate. On reconsideration, the bankruptcy court acknowledged that it granted the stay relief in error. Thereafter, the defendant submitted a monthly fee application to the bankruptcy court requesting compensation for work performed on the stay relief motion. The plaintiffs did not contest the application, and the bankruptcy court entered an order granting the defendant the majority of the requested fees and expenses.

The plaintiffs' second malpractice claim alleged that the defendant failed to file the requirement Chapter 11 monthly operating reports, causing the case to be converted from Chapter 11 to Chapter 7. As a result, the plaintiffs fired the defendant and hired a new attorney, who successfully moved for reconsideration of the conversion.

The plaintiffs' Chapter 11 case continued for two additional years. In this time, plaintiffs hired another law firm to negotiate and file a plan of reorganization. The plan specifically allowed the defendant's administrative claim for fees stemming from his prior fee application approved by the bankruptcy court. In addition, prior to plan confirmation, the defendant sought, in two separate motions, to collect his fees by filing a motion to compel payment. Thereafter, the plaintiffs objected to payment indicating that they were prepared to file a malpractice suit.

After the plaintiffs' exit from bankruptcy, the plaintiffs filed a malpractice complaint in the Superior Court of New Jersey that was removed to the District Court. The District Court dismissed the malpractice suit on the basis that it was previously litigated before the Bankruptcy Court and barred by *res judicata*. The Third Circuit affirmed.

In affirming, the Third Circuit Court restated that under the doctrine of *res judicata* a suit is barred where there is (1) a final judgment on the merits in a prior action involving (2) the same parties (or their privies) and (3) the same cause of action.

The issue in this case revolved around the third prong. The Third Circuit noted that under this prong the court typically examines whether there is an "essential similarity" of the underlying events giving rise to the various legal claims. However, the court emphasized that if prior litigation occurred during bankruptcy proceeding, it complicates the claim preclusion analysis. In such instances, a court must look to the individual proceedings within the bankruptcy and examine whether "the factual underpinnings, theory of the case, and relief sought

against the parties to the proceeding are so close to a claim actually litigated in the bankruptcy that it would be unreasonable not to have brought them in both at the same time in the bankruptcy forum.”

After reviewing the plaintiffs’ actions during the pendency of the bankruptcy case, the court found that it was unreasonable not to have brought the malpractice claims contemporaneously before the bankruptcy court.

First, the court found that the plaintiffs should have objected to the defendant’s fee application which requested for compensation for his alleged mishandling of the stay relief motion. The court reasoned that the fee application constituted a “contested matter” under 11 U.S.C. § 330, which requires by statute that the court inquire into the nature and quality of the defendant’s legal services, including whether he demonstrated skill and experience in the bankruptcy field.

The Third Circuit noted that the plaintiff’s subsequent malpractice claim turned exactly on whether the defendant demonstrated such skill or breached his duty of care owed to the client. Thus, the Third Circuit held (1) that by granting the fee application, the bankruptcy court implicitly found that the defendant’s services in responding to the stay relief motion were at least acceptable and (2) as a result, that it was unreasonable for plaintiffs not to have objected to the fee application prior to its approval.

The Third Circuit reached a similar conclusion in regards to the defendant’s failure to file monthly operating reports. The Third Circuit noted that the plaintiffs had multiple opportunities to, yet failed to, challenge the defendant’s omissions during the plan confirmation litigation and the intertwined motions to compel payment. Specifically, the Third Circuit noted the fact the plaintiffs themselves proposed a plan that provided the defendant a right to payment of his fees and “[y]et they did not object to the confirmation of that Plan, disclose to creditors their intent to file a malpractice action in the Plan itself or in the required disclosure under 11 U.S.C. § 1125, amend their asset schedules under 11 U.S.C. § 521 to reflect their contingent claim against the defendant, or otherwise make their discontent known to the Bankruptcy Court.”

Based on the Plaintiffs’ delay in raising objections, the Third Circuit observed that they wished to avoid litigating their malpractice claim until after the bankruptcy case. The Third Circuit noted that this was concerning because pursuant to 11 U.S.C. § 1115(a) malpractice claims were property of the bankruptcy estate because they accrued after the commencement of the bankruptcy case, but before plan confirmation. Accordingly, it was the estate, not the individual plaintiffs, that was harmed by the defendant’s malpractice. As a result, the Third Circuit emphasized that plaintiffs’ failure to raise the claim prior to confirmation deprived the estate of potential assets that could have been used to satisfy other claims and deprived creditors of the opportunity to negotiate over the disposition of those funds when considering the plan.

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Fifth Circuit

***Norris v. Causey*, Bk No. 16-30339,
2017 WL 3599878, , --- F.3d --- (5th Cir. Aug. 22, 2017)**

In this case, the Fifth Circuit considered whether a district court could void a judgment under a Rule 60(b)(4) motion on the basis of defendants' argument that plaintiffs lacked standing to bring their claim because their "failure to disclose the claim in [a prior] bankruptcy meant [the bankruptcy court's] abandonment of the claim was improper and the trustee should be considered the real party in interest."

Plaintiffs, the Norrises, entered into a joint venture with defendants, the Causeys, to supply funds to purchase hurricane-damaged properties, which defendants would renovate and sell for a profit. The plaintiffs and defendants agreed to divide the profit evenly. In order to fulfill their end of the bargain, plaintiffs obtained a home equity loan, then transferred \$94,000 of those funds to defendants, who spend them on personal items instead of for renovation of the properties pursuant to the joint venture agreement. Defendants also stopped paying plaintiffs interest accumulating on the plaintiffs' home equity loan, leading plaintiffs to file for Chapter 7 bankruptcy. In the bankruptcy (in the Eastern District of Michigan), plaintiffs initially failed to list their potential claim against defendants in their bankruptcy schedules, though later, the trustee's report referred to the claim with an estimated value of only \$1,000. The bankruptcy trustee's final report expressly abandoned the claim to plaintiffs, and the abandonment became final in 2012.

Thereafter, plaintiffs sued defendants, and a bench trial ensued. The district courts awarded damages and attorney's fees and costs to plaintiffs against defendants. The parties cross-appealed. After commencement of the appeals, the bankruptcy court reopened the bankruptcy case, stating "it appear[s] that Debtors may have intentionally [misled] the Court as to their assets and said asset appears to be an asset of the Debtor's Estate." Thereafter, defendants filed motions under Rule 60(b)(4) seeking to set aside the judgment as void, arguing that plaintiffs lacked standing because the bankruptcy trustee – not plaintiffs – was the real party in interest. The Fifth Circuit, reasoning that only "rare defects" – namely, defects in subject matter jurisdiction or personal jurisdiction, or a violation of due process – will render a judgment void. The Court held that although standing and capacity issues are often intermingled, "there is a key jurisdictional distinction between a challenge that a plaintiff lacks Article III standing and one that she is not the real party in interest." While a problem with subject matter jurisdiction cannot be waived, by comparison, a real-party-in-interest challenge "is an affirmative defense that must be asserted with reasonable promptness." Thus, even if the trustee should have brought the suit instead of plaintiffs, defendants were not entitled to relief under Rule 60(b)(4).

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Ninth Circuit

***DZ Bank AG Deutsche Zentral-Genossenschaft Bank v. Meyer (In re Meyer)*, No. 15-35086, 2017 WL 3623262, ___F.3d ___ (9th Cir. Aug. 24, 2017)**

In *In re Meyer*, the Ninth Circuit reversed the district court's affirmation of the bankruptcy court's decision that a debt was nondischargeable. The Circuit held that the bankruptcy court correctly determined that the Debtor engaged in a fraudulent transfer which amounted to actual fraud, but held that the bankruptcy court erred in limiting the nondischargeable debt to the amount of the transfer.

The creditor acquired a \$1.7 million note executed by Debtor's business Choice Cash Advance LLC ("Choice"), which was secured by the assets of Choice and personally guaranteed by the Debtor. Debtor entered into multiple forbearance agreements while engaging in a series of transfers designed to put his assets out of the reach of his creditors. Debtor first transferred assets valued at \$123,000 from Choice to Meyer Insurance ("MI"), a closely held corporation in which Debtor owned 100% of the shares. Debtor then transferred all of MI's assets to another entity for no consideration. At the time of the transfer, MI's assets had a fair market value of \$385,000. The transfers left Choice and MI insolvent. Choice and the Debtor then defaulted on the note and filed bankruptcy.

Applying Washington's fraudulent transfer law, the bankruptcy court determined that the transfer of assets out of MI was fraudulent and therefore constituted actual fraud under §523(a)(2)(A). However, the bankruptcy court limited its judgment to \$123,000, which was the value of assets transferred from Choice in which the creditor had a security interest.

The Ninth Circuit held that the nondischargeable debt was \$385,000, the full amount that the creditor would have recovered had it been able to execute against the Debtor's ownership interest in MI prior to the transfers.

***Bank of New York Mellon v. Watt (In re Watt)*, No. 15-35086, 2017 WL 3496034, ___ F.3d. ___ (9th Cir. Aug. 16, 2017)**

In *In re Watt*, the Ninth Circuit dismissed an appeal from a district court's order vacating the bankruptcy court's confirmation of a Chapter 13 plan for lack of jurisdiction. The Circuit held that an order vacating confirmation is not a final appealable order.

Debtors' Chapter 13 plan proposed to vest title to Debtors' home in secured creditor BNY Mellon over the bank's objection. The district court reversed on the basis that a Chapter 13 plan cannot require an unconsenting creditor to take title to property. Debtors appealed the district court's order and subsequently proposed an amended plan and the sale of the property under §363(b). The bankruptcy court approved the sale and confirmed the amended plan.

Relying on *Bullard v. Blue Hills Bank*, 135 S.Ct. 1686 (2015) which "raised the bar for finality," the Circuit held that because the district court did not "finally dispose of a discrete dispute" when it vacated the confirmation order, the district court order was not final and appealable. The Circuit noted that the question of mandatory vesting of property is an important and recurring legal question and Debtors had alternative channels for seeking appellate review including the general interlocutory appeals statute, 28 U.S.C. §1292(b) and bankruptcy-specific certification procedures of 28 U.S.C. §158(d)(2).

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***Zazzali v. United States of America (In re DBSI, Inc.)*, No. 16-35597,
WL 3760847, __F.3d__ (9th Cir. Aug. 31, 2017)**

In *Zazzali v. United States of America (In re DBSI, Inc.)*, debtor DBSI, Inc. and its affiliated entities engaged in the acquisition, development, management of commercial real estate properties through the operation of a Ponzi scheme, which ultimately resulted in the indictment and conviction of several of company insiders. DBSI was set up as an S corporation, and while still in operation, made tax payments of approximately \$17 million on behalf of the company's shareholders to the Internal Revenue Service (IRS) between 2005 and 2008. Notably, the vast majority of these payments were made on behalf of two of the largest shareholders to whom the IRS eventually refunded about \$3.6 million in overpayments to them. DBSI, Inc. filed for bankruptcy in 2008 with a plan of liquidation confirmed in 2010. The trustee commenced an adversary proceeding to recover DBSI's fraudulent transfers to the IRS under sections 544 and 547 of the Bankruptcy code and Idaho State's fraudulent transfer act. The bankruptcy court denied in part the government's motion to dismiss and the district court affirmed.

On appeal to the Ninth Circuit, the government argued that because there is no actual unsecured creditor who could pursue a claim against the IRS outside of bankruptcy, the trustee is likewise prevented from bringing a section 544(b)(1) claim in bankruptcy court. The Ninth Circuit disagreed and held that section 106(a)(1)'s abrogation of sovereign immunity is absolute with respect to section 544(b)(1) and thus includes the derivative state law claim on which a section 544(b)(1) claim is based.

The Ninth Circuit not only considered the particular statutory language at issue but also the language and design of the statute as a whole. Read in light of section 106(a)(1)'s clear abrogation of sovereign immunity, section 544(b)(1) meant that a trustee need only identify an unsecured creditor, who, but for sovereign immunity, could bring an avoidance action against the IRS. The court noted that its interpretation of the interplay between these statutes is further bolstered by the fact that section 106(a)(1) was enacted after section 544(b)(1).

The court also disagreed with the Seventh Circuit's decision in *EAR*, which addressed a nearly identical situation but reached the opposite result. First, the Ninth Circuit court takes issue with the *EAR* court's application of the second step of a two-step inquiry from the Supreme Court case *FDIC v. Meyer*, 510 U.S. 471 (1994): whether the source of the substantive law upon which the claimant relies provides an avenue for relief. Contrary to *EAR*, the court answered this in the affirmative and concluded that these statutes envisioned the government as a potential defendant largely based on the fact that under both the bankruptcy code and Idaho's UFTA, debtors and creditors are fined to include the government. Second, the Ninth Circuit believes

that its holding is *not* at odds with the Appropriations Clause and Supremacy Clause. Dicta in *EAR* suggest that the Appropriations Clause prevents any creditor from recovering against the federal government in a state court because money cannot be taken from the treasury without congressional approval. In a similar vein, the Supremacy Clause prevents states from enabling their resident to recover tax payments directly from the United States. In response, the Ninth Circuit simply highlighted that these points ignore the federal nature of a claim under section 544(b)(1). In particular, and respectively, recovery of fraudulent transfers is authorized under federal law (i.e., section 550 of the Bankruptcy Codes), and section 544(b)(1) does not authorize a trustee to bring an avoidance action in state court but instead, the statute permits a trustee to pursue a federal cause of action in bankruptcy court.

Finally, the court believed that its holding is supported by both equitable principles and the object and policy of the bankruptcy code. Specifically, in allowing for the avoidability of transfers made to the IRS, Congress ensured that the IRS is on equal footing with all other creditors.

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Tenth Circuit

***Sian v. Montoya (In re Sandia Resorts, Inc.)*, No. 15-11532,
2017 WL 3725924, BAP No. NM-17-003 (BAP 10th Cir. Aug. 30, 2017)**

In *Sian v. Montoya (In re Sandia Resorts, Inc.)*, No. NM-17-003, 2017 WL 3725924 (BAP 10th Cir. Aug. 30, 2017), the BAP dismissed as statutorily moot an appeal by the debtor's sole shareholder of an order authorizing the sale of the debtor's property, a hotel, under Code Section 363(m) because the appellant-shareholder failed to obtain a stay pending appeal, the sale closed, title passed and a significant part of the sale proceeds had been distributed to third parties. The appellant-shareholder sought a stay pending appeal from the bankruptcy court which denied the motion; but he did not seek a stay from the BAP; the sale closed after the court overruled the appellant-shareholder's objection based on a New Mexico statute. After closing title passed to the purchaser, which had bought the underlying promissory note from the original lender, and \$316,445 of the \$550,000 cash portion of the purchase price had been transferred to various taxing authorities. The BAP explained that Section 363(m) moots an appeal where a party appealing from a sale order fails to obtain a stay and the property is sold to a "good faith" purchaser, unless any other applicable law allows a court to fashion equitable relief which does not affect the validity of the sale. The BAP found that, while it could have affirmed without reaching the issue of whether the purchaser was entitled to the protections afforded by Section 363(m) because the appellant-shareholder neglected to provide a transcript of the sale hearing, the BAP nevertheless concluded that the purchaser made the purchase in "good faith." Next, the BAP explained that the appellant-shareholder failed to offer up any form of equitable relief that

would not have affected the validity of the sale that could preclude a finding of statutory mootness. Nevertheless, the BAP went on to conclude that, even if were to reach the merits of the appeal, it would affirm the bankruptcy court's decision to overrule the appellant-shareholder's sale objection, including that a cited New Mexico statute, Section 47-1-7, was inapplicable because it "governs situations where one party is seeking to convey property on behalf of a different party, usually the owner," which didn't address the facts before the court which involved a lender's sale of the note to the purchaser.

***SE Property Holdings, LLC v. Stewart (In re Stewart)*, No. 15-12215
2017 WL 3575698, No. 16-1117-JDL (Bankr. W.D. Okla. Aug. 17, 2017)**

In SE Property Holdings, LLC v. Stewart (In re Stewart), No. 16-1117-JDL, 2017 WL 3575698 (Bankr. W.D. Okla. Aug. 17, 2017), the court dismissed an adversary proceeding with prejudice which sought to substantively consolidate several non-debtor entities to jointly administered cases of two individuals, one of which managed, and held or used to hold interests in those entities. The court previously dismissed the initial complaint seeking the same relief without prejudice, explaining that additional facts had to be pled as to the identity of the non-debtor's creditors and how they would benefit from substantial consolidation. The court had stated that the party seeking the extraordinary relief of substantive consolidation of non-debtors into a debtor had to show "(1) a substantial identity between the entities (assets of the entities in question are "hopelessly co-mingled"), (2) consolidation is necessary to avoid some harm or to realize some benefit, (3) that if a creditor objects on the grounds that it relied on the separate credit of one of the entities to its prejudice consolidation may be ordered only if the benefits heavily outweigh the harm, and (4) that consolidation was for the benefit of all creditors and that benefits of consolidation outweigh any resulting harm to general creditors of the entities." The court noted that the only 2 creditors of one of the non-debtors which together held some \$20 Million in claims against that non-debtor objected, and it found that objection "highly significant, if not determinative," quoting from another case as follows: "Better, we think, to ask are any creditors going to be hurt by this consolidation and, if the answer to that is yes (or more properly, if the one seeking consolidation cannot prove the opposite), consolidation should be denied in almost every case." The court also rejected the proposition that alleged misconduct of a non-debtor and its creditor(s) was a basis to impose substantial consolidation on other creditors of the non-debtor, explaining that to do so would "create a new element for substantive consolidation while ignoring the long-standing requirement that no harm be done to other creditors...." In rejecting the proposition being urged on it, the court characterized the remedy of substantial consolidation as "draconian," emphasizing the extraordinary nature of the remedy, something that other courts have held or suggested that the appropriate procedural mechanism would be the filing of an involuntary petition against the non-debtor entity to provide the statutory and procedural protections afforded by Section 303.

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