Bankruptcy Circuit Update

Featuring cases from July 2016

Special Announcement
Group Section Conference Call to Discuss Significant Cases

This month our writers Circuit Writers and Section Leaders will be convening our second section-wide conference call on **Friday, August 26th, at 4:00 E.S.T./1:00 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**. We had a good first kick-off to this section-wide conference call last month and are looking forward to the second call! 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

United Sur. & Indem. Co. v. López-Muñoz (In re López-Muñoz)
BAP NO. PR 16-011, 2016 WL 4061144 (B.A.P. 1st Cir., July 28, 2016)

Creditor of chapter 11 individual debtor filed a motion to appoint a chapter 11 trustee pursuant to 11 U.S.C. § 1104(a)(1) and (2) arguing that debtor made pre-petition fraudulent transfers and failed to make important disclosures about the transfers in the bankruptcy case. In addition, the creditor argued that cause existed to appoint a Chapter 11 trustee because the debtor had a conflict of interest with the estate's alleged fraudulent transfer claim against one of the debtor's companies.

At the evidentiary hearing on the creditor's motion to appoint a chapter 11 trustee, the creditor's expert, a CPA, was limited to rebuttal testimony because the creditor failed to disclose the expert on its expert witness list. The court noted that this "proved to be a hurdle that [the creditor] did not adequately overcome."

Fraud is not defined in Section 1104(a)(1) or anywhere else in the Bankruptcy Code. "There is a dearth of cases in which courts have found fraud on the part of the debtor-in-possession justified the appointment of a trustee…[M]ost courts consider the totality of the circumstances to ascertain whether there is sufficient evidence to find that the debtor intended to defraud creditors, and whether the debtor's actions as a whole rise to the level of fraud, dishonesty, or gross mismanagement justifying a trustee's appointment."

The Panel found there was no abuse of discretion in the bankruptcy court's finding that the debtor rebutted the presumption that his pre-petition transfers were made to defraud his creditors. The bankruptcy court cited the debtor's CPA's testimony that the transfers had "no

material effect" on the bankruptcy estate and found that the debtor's testimony as to the reasons for the transfers was credible.

As to the debtor's alleged conflict of interest, the Panel held that there was no clear error in finding there was no cause of action. The creditor failed to offer testimony to contradict the debtor's CPA's testimony that undermined the creditor's calculation of the claim and failed to submit evidence to support its assertions challenging certain expense amounts relevant to the determination of whether there was a claim.

The Panel also held that the bankruptcy court did not abuse its discretion when it determined that the creditor did not meet its burden to demonstrate that the benefits of a outweighed the costs to the estate. "[The creditor] never delivered the evidence to demonstrate that the value of the assets if sold by a trustee would generate funds sufficient to pay the secured creditors in full and leave a balance for other creditors. Nor did it offer evidence that the Debtor's rehabilitation prospects were in jeopardy, or that the business community and the other creditors lacked confidence in the Debtor and his ability to reorganize his financial affairs to fairly address their claims."

The bankruptcy court's order denying the motion to appoint a chapter 11 trustee was affirmed.

***Andover Covered Bridge, LLC v. Harrington (In re Andover Covered Bridge, LLC*)**
BAP NO. EP 16-005, 2016 WL 4035505 (B.A.P. 1st Cir., July 26, 2015)

Chapter 11 debtor owned real estate in Maine where a farm, a farm store and a seasonal amusement center were operated by various affiliates of the debtor. Business slowed substantially at the amusement center after an accident on a hayride, causing a severe cash flow problem which resulted in the debtor's inability to make its mortgage payment. The debtor filed a chapter 11 bankruptcy as a single asset real estate case. Post-petition, the debtor failed to timely file monthly operating reports, failed to produce financial information requested by the U.S. Trustee and failed to make the mortgage payments on its only asset. The U.S. Trustee moved to dismiss or convert the case pursuant to 11 U.S.C. 1112(b)(4)(F) and (H) and 1112(b)(4)(A). In affirming the bankruptcy court's dismissal of the case, the Bankruptcy Appellate Panel for the First Circuit emphasized the importance of monthly reports and financial disclosures in a Chapter 11 case. It rejected the debtor's argument the U.S. Trustee's failure to notify it of non-compliance with the filing requirement and the monthly operating reports being caught in its counsel's spam filer were sufficient reasons to excuse timely filing of the reports. "It was the Debtor's obligation to comply with its reporting requirements and to ensure that its counsel timely filed the reports with the U.S. Trustee and the bankruptcy court. The U.S. Trustee had no obligation to remind the Debtor or his counsel of any failure to comply." Therefore, cause existed to dismiss under 11 U.S.C. 1112(b)(4)(F) and (H).

The Panel also did not find any error in the bankruptcy court's dismissal of the case pursuant to 11 U.S.C. § 1112(b)(4)(A). Based on the evidence, the debtor had no ability to pay its debts (primarily the mortgage) because it had no income. Still, the debtor argued that it intended to propose a liquidating plan and therefore the bankruptcy court erred in holding that

there was the absence of a likelihood of rehabilitation. However, "there is nothing in the record that suggests financial viability for the Debtor was reasonably likely, or it would suddenly be able to increase its cash flow." As a result, the Panel held that the bankruptcy court did not err when it held that the debtor would not be able to service its debt and did not have a reasonable likelihood of rehabilitation.

Last, the Panel reviewed the bankruptcy court's decision to dismiss rather than convert under § 1112(b)(2). "Courts have much discretion in determining whether there are unusual circumstances that should prevent dismissal or conversion." Because cause existed for dismissal under § 1112(b)(4)(A), the § 1112(b)(2) exception to conversion or dismissal did not apply. Regardless, the debtor failed to argue that any unusual circumstances existed that would have established that conversion or dismissal was not in the best interests of creditors and the record did not provide any support for the debtor. Therefore, the § 1112(b)(2) exception to dismissal did not apply.

In re Hoover
No. 15–2383, 2016 WL 3606918 (1st Circuit, July 5, 2015)

The individual Chapter 11 debtor owned and operated a Halloween costume business. The United States Trustee moved to dismiss or convert the case under 11 U.S.C. § 1112(b). After an evidentiary hearing the bankruptcy court granted the motion and converted the case to a chapter 7. The district court affirmed. On appeal, the First Circuit held that the bankruptcy court did not abuse its discretion in finding that there was not a "reasonable likelihood of rehabilitation" for the debtor under 11 U.S.C. 1112(b)(4)(A). According to the debtor's Profit and Loss Statement, the costume business loss a substantial amount of money and was only making a minimal profit despite the fact that it was not replenishing inventory and was not paying secured creditors. The Court held that the bankruptcy court appropriately rejected the debtor's testimony regarding his plan to turn the business around. Further, the First Court found no error of law or abuse of discretion in the bankruptcy court's decision to convert rather than dismiss the case. The bankruptcy court had to choose between "two likely bleak alternatives" and had "ample discretion to conclude that prompt conversion rather than further diminution was in the best interests of creditors, especially where no creditor opposed conversion as hostile to its interests."

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Second Circuit

John Nagle Co. v. McCarthy (In re Cousins Fish Mkt., Inc.)
No. 15-3710, 2016 WL 3854277 (2d Cir., July 12, 2016)

The Second Circuit affirmed the judgment of the district court affirming the bankruptcy court's judgment in an adversary proceeding against John Nagle Co. ("Nagle"), a fish and seafood wholesaler. The bankruptcy court had awarded William J. McCarthy (the "Trustee"), as chapter 7 trustee to the bankruptcy estate of the Cousins Fish Market, Inc. ("Cousins"), $109,325.01 after ruling that certain transfers from Cousins to Nagle were avoidable preferences under Bankruptcy Code section 547(b). On appeal, Nagle argued that the bankruptcy court erred by (i) excluding certain documentary evidence and witness testimony from the bench trial, and (ii) concluding that Nagle failed to prove its two affirmative defenses under Bankruptcy Code sections 547(c)(1) and (c)(2).

The Second Circuit first held that the bankruptcy court did not abuse its discretion in excluding evidence from the bench trial that had not been produced to the Trustee during discovery. The bankruptcy court found that, although the new evidence was important to Nagle because Nagle would be unlikely to prove its affirmative defenses without it, other factors weighed in favor of exclusion. Specifically, the bankruptcy court found (i) that Nagle had failed to meaningfully explain why the evidence was not produced or disclosed, (ii) that prejudice to the Trustee would be substantial, given that discovery had been closed for more than three months, and (iii) that a continuance would be burdensome because the bench trial was scheduled to commence in the near future. Additionally, the bankruptcy court found that the personal witness testimony at issue would be improperly based on undisclosed evidence, not personal knowledge. As such, based on its review of this record, the Second Circuit held that the bankruptcy court did not abuse its discretion in excluding the evidence.

The Second Circuit then held that the bankruptcy court also did not err in ruling that Nagle failed to establish its affirmative defenses. Turning first to Nagle's contemporaneous-exchange-for-new-value defense, the Second Circuit found that the bankruptcy court appropriately concluded that Nagle failed to prove the requisite intent because it introduced no testimony or contractual terms governing the transfers. The Second Circuit then considered Nagle's ordinary-course-of-business defense, and held that the bankruptcy court did not err in concluding that Nagle failed to prove a sufficient baseline of prior dealings between the parties because, although Nagle had submitted many invoices, the majority of these were dated within the preference period; in fact, only two of the checks tendered by Cousins were dated before the preference period. Therefore, based on the bankruptcy court's findings, which the Second Circuit found to be not clearly erroneous, and the lack of evidence regarding transfers in the pre-preference period, the Second Circuit affirmed the bankruptcy court's holding that Nagle failed to prove that the transfers at issue were made in the ordinary course of business.

Elliott v. Gen. Motors LLC (In re Motors Liquidation Co.)
No. 15-2844, 2016 WL 3766237 (2d Cir., July 13, 2016)

In this appeal, which stems from the bankruptcy of General Motors, the plaintiffs challenged the bankruptcy court's rulings that: (1) the court had jurisdiction, (2) enforcement of the sale order would not violate procedural due process, and (3) relief for any late-filed claims would be barred as equitably moot. The Second Circuit affirmed in part, reversed in part, and vacated in part, holding that (1) the bankruptcy court had subject matter jurisdiction over all of the contested issues regarding the sale order, (2) the "free and clear" provision of the sale order did not violate due process as to two of the four classes of the plaintiffs' claims, and (3) the bankruptcy court's holding regarding late-filed claims was advisory and should therefore be vacated.

This appeal arose from the 2009 bankruptcy of General Motors Corporation ("Old GM"). After posting significant losses during the financial crisis of 2007 and 2008, the U.S. Department of the Treasury loaned billions of dollars from the Troubled Asset Relief Program to buy the company time to improve its business model. When Old GM's private efforts failed, the company petitioned for Chapter 11 bankruptcy protection, and emerged forty days later through a 363 sale as the new General Motors LLC ("New GM").

Beginning in February 2014, New GM began recalling cars due to a potentially lethal defect in their ignition switches that resulted in full engine shutdowns, which also deactivated airbags and disabled power steering and braking. Many of the cars in question were built years before the bankruptcy, but individuals claiming harm from the ignition switch defect faced a potential barrier created by the bankruptcy process. In bankruptcy, Old GM had used Bankruptcy Code section 363 of the Bankruptcy Code to sell its assets to New GM "free and clear." The bankruptcy court's sale order (the "Sale Order") barred individuals from pursuing their claims against New GM as the successor corporation.

Various individuals nonetheless initiated class action lawsuits against New GM, asserting "successor liability" claims arising from the ignition switch defect. New GM argued that, because of the "free and clear" provision in the Sale Order, claims could only be brought against Old GM. The bankruptcy court agreed, and in April, 2015 it enforced the Sale Order to enjoin many of these claims against New GM. Though the bankruptcy court also determined that these plaintiffs did not have notice of the Sale Order as required by the Due Process Clause of the Fifth Amendment, the bankruptcy court denied plaintiffs relief from the Sale Order on all but a subset of claims. Finally, the bankruptcy court invoked the doctrine of equitable mootness to bar relief for would-be claims against a trust established in bankruptcy court to pay out unsecured claims against Old GM (the "GUC Trust"). The bankruptcy court entered judgment and certified the judgment for direct review by the Second Circuit. Four groups of plaintiffs appealed, as did New GM and GUC Trust.

The Second Circuit first addressed the bankruptcy court's subject matter jurisdiction to enforce the Sale Order. The plaintiffs challenged jurisdiction: (1) as a whole, to enjoin claims

against New GM, and (2) to issue a successive injunction. First, as to jurisdiction generally, the Second Circuit found that a bankruptcy court's authority to interpret and enforce a prior sale order falls under the formulation of "arising in" jurisdiction pursuant to 28 U.S.C. § 157(a), which was the case here; the bankruptcy court first interpreted the "free and clear" provision in the Sale Order that barred successor liability claims, and then decided whether to enforce that provision. The Second Circuit also dismissed the plaintiffs' arguments regarding a "successive injunction." In certain provisions of the Sale Order, the bankruptcy court had included language that successor liability claims would be "forever prohibited and enjoined." Contrary to the plaintiffs' arguments, New GM was not seeking an injunction to stop plaintiffs from violating that prior injunction. Instead, New GM wanted the bankruptcy court to confirm that the Sale Order covered *these* plaintiffs. As such, the Second Circuit affirmed that the bankruptcy court had jurisdiction to interpret and enforce the Sale Order.

The Second Circuit then addressed the scope of the "free and clear" provision in the Sale Order, because this question implicated the related procedural due process analysis. The Second Circuit summarized the existing case law regarding this issue as follows: a bankruptcy court may approve a § 363 sale "free and clear" of successor liability claims if those claims flow from the debtor's ownership of the sold assets. Such a claim must arise from a (1) right to payment (2) that arose before the filing of the petition or resulted from pre-petition conduct fairly giving rise to the claim. Additionally, there must be some contact or relationship between the debtor and the claimant such that the claimant is identifiable.

The Second Circuit then applied these principles to: (1) pre-closing accident claims, (2) economic loss claims arising from the ignition switch defect or other defects, (3) independent claims relating only to New GM's conduct, and (4) claims brought by purchasers of used cars. The bankruptcy court assumed that the Sale Order's broad language suggested that all of these claims fell within the scope of the "free and clear" provision. The Second Circuit, however, held that while the first two sets of claims were covered by the Sale Order, the latter two sets of claims were not.

Firstly, the Second Circuit held that the pre-closing accident claims were clearly within the scope of the Sale Order, because such claims directly related to the ownership of the GM automaker's business; Old GM built cars with ignition switch defects, and these plaintiffs' claims were properly thought of as tort claims that arose before the filing of the petition. Indeed, the claims arose from accidents involving Old GM cars that occurred pre-emergence.

Secondly, the Second Circuit found that the economic loss claims arising from the ignition switch defect presented a closer call. Ultimately, the Second Circuit held that the economic losses claimed by these individuals were "contingent" claims that were covered by the Sale Order. In other words, though the ignition switch defect was already existing, it was not yet so patent that an individual could, as a practical matter, bring a case in court. Essentially, Old GM's creation of the ignition switch defect fairly gave rise to these claims, even if the claimants were unaware.

However, the Second Circuit found that the third class of claims, i.e., the independent claims, did not satisfy the Bankruptcy Code's limitation on claims. This class of claims was

based on New GM's wrongful conduct that occurred post-emergence, such as claims based on misrepresentations by New GM as to the safety of Old GM cars. These claims were based on New GM's post-petition conduct, and as such they were not claims based on a right to payment that arose before the filing of petition or that were based on pre-petition conduct. As such, the Second Circuit held that this class of claims was outside the scope of the Sale Order's "free and clear" provision.

Similarly, the Second Circuit held that the Sale Order also did not cover the claims brought by purchasers of used cars. These claimants were individuals who purchased Old GM cars after the closing, without knowledge of the defect or possible claims against New GM. They therefore had no relation with Old GM prior to bankruptcy. As such, the Second Circuit held that the Sale Order did not cover their claims.

Finally, the Second Circuit considered the plaintiffs' argument regarding equitable mootness. This doctrine allows appellate courts to dismiss bankruptcy appeals if, during the pendency of an appeal, events occur such that even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable. For example, bankruptcy appeals are often presumed to be equitably moot when a plan of reorganization has been substantially consummated.

The Second Circuit began its analysis of this issue by noting that "the oldest and most consistent thread in the federal law of justiciability is that federal courts will not give advisory opinions," and that such limitations apply to bankruptcy courts as well. Here, the bankruptcy court held that any relief from the GUC Trust would be equitably moot. However, the Second Circuit noted that the plaintiffs never sought relief from GUC Trust. The GUC Trust was not a litigant in the bankruptcy court, and protested its involvement in the case; the Second Circuit noted that the GUC Trust became involved in the case only at New GM's behest. In other words, though the GUC Trust sought *not* to be involved, the bankruptcy court ordered otherwise, and in doing so, the bankruptcy court was concerned with a "hypothetical" scenario involving the possibility that there "may be" late-filed claims against GUC Trust. The Second Circuit noted that it is ultimately the *parties*, and not the court, that must create the controversy, and therefore the Second Circuit vacated this judgment as an advisory opinion.

Krys v. Klejna
No. 14-3480, 2016 WL 4059542 (2d Cir., July 29, 2016)

The Second Circuit affirmed the district court's judgment dismissing the state law fraud claims brought by plaintiffs, a group of now-defunct hedge funds (the "Plaintiffs"), against defendants Dennis A. Klejna ("Klejna") and JPMorgan Chase & Co. ("JPM,"). The Plaintiffs argued (i) that the district court was required to abstain from hearing the case, which stemmed from matters relating to the bankruptcy of Refco, Inc., (ii) that the district court's dismissal of Klejna as defendant was improper, and (iii) that the district court's dismissal of the aiding and abetting claims against JPM was improper.

The Second Circuit first considered the Plaintiffs' argument regarding abstention. The Plaintiffs claimed that the district court was required to abstain from hearing the case under 28 U.S.C. § 1334(c)(2), which provides that, for state law causes of action "related to" (but not "arising under" or "arising in") title 11, the district court must abstain from hearing such proceeding if an action is commenced, and can be timely adjudicated, in a state forum of appropriate jurisdiction. Four factors are generally considered when deciding abstention under § 1334(c)(2) is warranted: (1) the backlog of the state court's calendar relative to the federal court's calendar; (2) the complexity of the issues presented and the respective expertise of each forum; (3) the status of the bankruptcy proceeding to which the state law claims are related; and (4) whether the state court proceeding would prolong the administration or liquidation of the estate.

The Second Circuit first held that the district court properly ruled that abstention was not required in this case. The Second Circuit noted that when the facts in a case are especially complex, the forum with greater familiarity with the record may likewise be expected to adjudicate the matter more expeditiously. As the district court properly recognized, remanding these fraud actions to state court would significantly slow the process of resolving such claims. Furthermore, in this case, (i) the applicable state law doctrines were well-established, (ii) many of the defendants had been dismissed, and the claims against those defendants would need to be litigated from scratch, and (iii) the bankruptcy proceedings of one of the Plaintiffs remained open, meaning that any damages awarded in this dispute could affect the administration of that estate. The Second Circuit therefore agreed with the district court that, in these circumstances, abstention was not mandatory.

The Second Circuit then turned to the Plaintiffs' argument that the district court's dismissal of Klejna as defendant was improper. Plaintiffs' amended complaint alleged that Klejna had diverted the Plaintiffs' funds from Refco LLC into unsegregated accounts at its unregulated, offshore subsidiary, Refco Capital Markets ("RCM"), where the funds were commingled for use in fraudulent activities designed to conceal Refco's losses, bolster Refco's financial statements, and enrich various individuals. The Plaintiffs therefore alleged, in essence, that Refco could not pay them back because it was looted and went bankrupt.

As in the district court, the Second Circuit held that the Plaintiffs lacked standing to sue Klejna. The Second Circuit noted that while the Plaintiffs had standing to sue for the excess funds that were taken out of the Refco accounts and moved to RCM, the lower court properly concluded that any damages to the Plaintiffs would not have flowed from that transfer, but instead from the underlying Refco fraud. The Plaintiffs lacked standing to sue for the Refco fraud, however, because their claims were derivative of the harm that occurred to Refco; in other words, the Plaintiffs' alleged damages were no different from those suffered by any other creditor of Refco, and to the extent that the Plaintiffs' damages arose from Refco's insolvency, they must be resolved in the bankruptcy proceeding because they are property of the estate. Furthermore, the Second Circuit noted that such claims had largely already been resolved; Klejna had settled with the Refco trustee (and payment pursuant to that settlement was made available for creditors to pursue); and the Plaintiffs had also previously settled with the RCM trustee and agreed to relinquish their claims in exchange for approximately $50 million. As such, permitting the Plaintiffs to bring their civil fraud claims against Klejna when they already had the

opportunity to recover as creditors in the bankruptcy proceedings would have potentially allowed for a double recovery. As such, the Second Circuit held that dismissal of the claims against Klejna was proper.

Finally, the Second Circuit considered the Plaintiffs' challenge of the district court's dismissal of their claims against JPM for aiding and abetting fraud. To plead aiding and abetting fraud under New York law, one must allege (1) that fraud was committed, (2) that the defendant had "actual knowledge" of the fraud, and (3) that the defendant provided substantial assistance to advance the commission of the fraud. Moreover, the Federal Rules of Civil Procedure require that a complaint for fraud, including claims for aiding and abetting fraud, is required to plead the circumstances constituting the fraud with particularity.

The Second Circuit held that the district court properly dismissed these claims because the Plaintiffs did not plead JPM's knowledge with particularity. The Plaintiffs' complaint alleged that a Refco party breached its fiduciary duty by transferring money to unsegregated accounts without authorization. Nothing in the complaint indicated, however, that JPM knew the transfers were unauthorized. While JPM may have known that the money was transferred from segregated to unsegregated accounts, this transfer in and of itself was not a breach of fiduciary duty without JPM having knowledge that the transfers were unauthorized. The Second Circuit therefore affirmed the district court's judgment in its entirety.

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Third Circuit

In re Quantum Foods, LLC, et al.
Case No. 14-1318 (KJC), 2016 WL 4011727, (Bankr. D. Del. July 25, 2016)

On a motion for judgment on the pleadings, Judge Kevin Carey of the Bankruptcy Court for the District of Delaware decided a matter of first impression—whether an allowed post-petition administrative expense claim can be used to set off preference liability.

The UCC sought to avoid and recover almost $ 14 million in prepetition transfers to Tyson, Inc. alleging that they were impermissible preferential transfers. Tyson counterclaimed, arguing that it should be able to set off the transfers with an administrative expense claim it had against the estate for post-petition chicken deliveries.

The question before the court was whether Tyson's prepetition transfers and post-petition sale would create an ordinary setoff claim or, as the UCC argued, merely a "disguised" post-

petition new value defense under § 547(c)(4) because it had the effect of reducing the amount of preferential transfers returned to the estate.

The court noted that although post-petition activity may not factor into the preference calculation (citing *In re Friedman's, Inc.*, 738 F.3d 547 (3d Cir. 2013)), the "new value" defense to preferential transfers in § 547(c)(4) did not apply to Tyson's post-petition sale because the defense is explicitly limited to pre-petition activity. Further, Tyson's setoff claim did not affect the "bottom line of the preference calculation . . . only the amount *paid* to the estate" and that the preference claim was affected only externally, not internally. Rather, the claim was clearly a "setoff" because it was a counterclaim demand arising out of an action extrinsic to the preference action.

After establishing that the claim was a setoff, the court concluded that it would be allowed under applicable setoff rules. In so concluding, the court first noted that the definition of setoff was satisfied because the opposing obligations—Tyson's administrative claim and the UCC's preference claim—were rights to payment that both arose post-petition. Lastly, the court rejected the UCC's argument that § 502(d) prohibited the setoff claiming that § 502 did not apply to Tyson's administrative claim, echoing previous cases that found that extending § 502(d) to cover administrative claims would hinder reorganization by disincentivizing vendors from extending post-petition credit to a debtor.

In re GSE Environmental Inc., et al.
Case No. 15-50377 (MFW), 2016 WL 3963978, (Bankr. D. Del. July 18, 2016)

Judge Mary Walrath of the Bankruptcy Court for the District of Delaware granted debtors' motion for judgment on the pleadings, holding that a claim filed by its interim CEO and president was an equity security.

Part of the CEO's monthly compensation included $86,000 payable in company stock that remained unpaid when debtors filed chapter 11 bankruptcy petitions. The debtors sought a declaration from the court that the unpaid amount was not a general unsecured claim or, alternatively, that the claim should be subordinated under § 510(b). Analyzing the Code's definition of "equity security" and several interpretations in case law granting broad readings of what constitutes a purchase of an equity security, the court concluded that "common stock received in exchange for labor constitutes a purchase and sale of a security under the Code" and that any entity, including an employee, "asserting an equity interest is not a creditor and does not have a 'claim' under the Code."

Lastly, the court rejected the CEO's argument that because the amount of stock compensation was at a fixed dollar amount and not a fixed amount of shares, the amount owed to him was elevated to a general unsecured claim; reasoning that because the compensation remained stock, and not cash, the CEO held an equity interest and not a claim.

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Fifth Circuit

Kessler v. Wilson (In re Kessler)
No. 15-11252, 2016 WL 3667575 (5th Cir. July 8, 2016).

After the bankruptcy court denied the chapter 13 debtors' motion for discharge, the debtors appealed arguing, in part, that payments on post-petition mortgage debt were not provided for "under the plan" and thus nonpayment did not bar discharge. The district court affirmed the bankruptcy and the debtors appealed. At the Fifth Circuit, the debtors essentially argued that because post-petition mortgage payments fall outside of their plan, they cannot be required for discharge under § 1328(a).

The Fifth Circuit cited to its opinion in *In re Foster*, where the court held that both the payments toward curing pre-petition mortgage arrears and the post-petition maintenance payments fall under a chapter 13 plan because both payments concern the same claim. 670 F.2d 478, 493 (5th Cir. 1982). The Fifth Circuit found that because the debtors failed to complete post-petition mortgage payments that fall under the plan, they do not qualify for discharge under the plain terms of § 1328(a), which instructs a court to grant a discharge only after completion of all payments under the plan.

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Eighth Circuit

Civic Partners Sioux City, LLC v Main Street
No. 15-6024, 2016 WL 3902658 (8th Cir.BAP. July 19 2016)

In this matter the BAP reversed the bankruptcy court's dismissal of the debtor's chapter 11 case. Prior to the bankruptcy filing, the debtor, an owner of commercial real estate, in an effort to restructure, entered into agreements with its two principle creditors, a bank lender and Sioux City (the "City"), and an amended lease with its primary tenant. The amended lease provided that if the city council failed to ratify the agreement with the City, the debtor could declare the amended lease null and void. Ultimately the city council did not ratify the agreement

and the debtor gave notice that it was terminating the amended lease in the days before the bankruptcy filing.

During the bankruptcy proceedings, the bankruptcy court held that the amended lease was still in affect because Iowa rescission law did not allow the termination of the amended lease unless the debtor returned a $200,000 "restructuring payment" it received from the tenant and, alternatively, that the consent from the lender was required for termination. The debtor sought to appeal this ruling at various times throughout the proceeding, but these appeals were dismissed on the basis that the bankruptcy court's order was interlocutory. The debtor was unable to confirm a plan of reorganization because the bankruptcy court determined the plan was not feasible. The case was then dismissed on motion by the lender.

The BAP, on review, reversed the dismissal order. The BAP determined that the bankruptcy court had erred in holding the amended lease could not be terminated. The BAP held that because of the termination provision in the amended lease, the debtor had a contractual right to terminate the contract and it did not constitute rescission. The BAP also held that consent of the lender was not required. While the agreement between the debtor and the lender provided that the debtor would not terminate the amended lease without obtaining the lender's consent, the failure to do did not make the debtor's termination ineffective, but may have been a default under that separate agreement. The dismissal order was reversed because, due to the bankruptcy court's ruling, the debtor had not had the opportunity to propose a plan based on the original lease and the bankruptcy court had not considered whether such a plan was confirmable.

In re Steward
No. 15-1857, No. 15-1988, 2016 WL 3629028 (8th Cir. July 7, 2016)

This matter arose from the debtor filing a pro se adversary proceeding against her prior bankruptcy counsel for abandoning his representation, which the debtor alleged caused her to miss the deadline to rescind a reaffirmation agreement. Following a hearing, the bankruptcy court entered an order deeming the complaint as a motion to disgorge attorney's fees based on inadequate representation.

The matter proceeded on that basis, and the bankruptcy court entered judgment for the debtor, awarding $495 in fees to be disgorged. Additionally, for their numerous abuses of the discovery process and failures to comply with court orders, the bankruptcy court found the defendant in contempt, imposed $30,000 in sanctions, made the defendant's attorney jointly and severally liable for those sanctions and imposed another $19,720 for attorney's fees incurred by the debtor's counsel in litigating discovery. The bankruptcy court also suspended the defendant and his counsel from practice before the US Bankruptcy Court for the Eastern District of Missouri and referred them to the District Court, Office of the U.S. Trustee, and the Missouri Supreme Court for investigation and disciplinary action. On appeal the district court affirmed the bankruptcy court in all respects.

Appellants raised a number of issues before the Eighth Circuit in challenging the bankruptcy court's judgment. First, Appellants argued that the debtor lacked standing to bring a

motion to disgorge, a claim that belonged to the chapter 7 trustee. The Eighth Circuit upheld the district court's conclusion that in certifying that the estate was fully administered and requesting to be discharged of further duties, both before and after the bankruptcy case was reopened and the motion was filed, the trustee had abandoned the claim giving the debtor standing to pursue it.

Second, Appellants argued that the bankruptcy court had erred in failing to grant any of the three motions to recuse filed in the bankruptcy proceedings. The Eighth Circuit rejected this argument because the motions were not timely, the first being filed four months after the Appellants involvement in the case, and only after an order to compel discovery was entered against them. The Court further held that there was no evidence produced to show the bankruptcy judge was impartial.

Next, Appellants claimed that the bankruptcy court erred in construing the pleading filed as an adversary complaint as a motion to disgorge, citing to FRBP Rule 9005, which provides that the court may order the correction of errors that do not affect substantial rights. The Eighth Circuit rejected Appellants' arguments on this point noting that accepting the claim would "suggest that Appellants had a substantive right not to face a motion for disgorgement based on the allegations that they had provided inadequate representation" which finds no support in law.

Appellants also raised arguments that the bankruptcy court erred in (1) failing to dismiss the case when they directed a payment of $199 to the debtor's counsel; (2) denying a motion to approve a settlement; and (3) sanctioning Appellants for failing to meet their discovery obligations following the parities agreement on settlement. All were rejected by the Court. Also rejected by the Court was the argument that the motion should have been dismissed under the doctrine of unclean hands due to false statements in the initial petition, given that it was Appellants who directed the debtor to include the false information.

Finally, the Eighth Circuit upheld the sanctions imposed by the bankruptcy court, finding that the monetary sanctions were warranted given Appellants' bad faith conduct. The Court affirmed the Appellant suspensions holding that the bankruptcy court had the inherent authority to discipline authorities appearing before it, including the right to control admission to their bar.

In re Hurst
No. 15-6031, 2016 WL 3902659 (8th Cir. BAPJuly 19, 2016)

The debtor appealed to the BAP from the bankruptcy court's order denying her request to discharge her student loans for undue hardship. The debtor obtained a $4,000 Perkins loan to attend Sothern Arkansas University for the 1994-1995 academic year, but following her first school year, while out of state for a summer job, suffered an injury that prevented her return to school. The debtor remained out of state until 2009, having never returned to school. The debtor, whose student loan debt has grown to approximately $7,500 is presently 66, suffers from vision and hearing problems, has only maintained low paying jobs, and is reliant on social security for more than half of her annual income.

The BAP affirmed the bankruptcy court's denial of the request for discharge, finding that the bankruptcy court did not err in determining that the debtor's average income of $1,800 a month and $1482.02 in expenses would allow the debtor to make some payment on the student loans.

Roussel v. Clear Sky Properties
No. 15-3048, 2016 WL 3974164 (8th Cir. July 25, 2016)

Here, the debtor sought to challenge the determination that a judgment debt was non-dischargeable. Prior to the bankruptcy filing, in a state court action, a judgment was entered against the debtor for breach of fiduciary duty and breach of contract awarding actual and punitive damages, as well as attorney's fees. Initially, the bankruptcy court found that the judgment debt dischargeable, but was reversed on appeal by the district court. The debtor then appealed to the Eighth Circuit.

The debtor argued that the district court erred in applying collateral estoppel to find that he acted maliciously under 11 U.S.C § 523(a)(6). The debtor argued that the jury instruction which allowed for an award of punitive damages was not a basis to for applying collateral estoppel on the issue of malice. The Eighth Circuit rejected this argument, noting that the instruction required the jury to consider the likelihood of harm objectively and whether the debtor had acted while intending or expecting the consequences. The Court also held that the district court had not erred in finding that the debtor acted willfully, upholding the district court's ruling that judgment debt was non-dischargeable.

Nelson v. Midland Credit Management
No. 15-2984, 2016 WL 3672073, (8th Cir. July 11, 2016)

In this matter, the debtor sought to bring a suit against a debt collector for filing a proof of claim on a time-barred debt in the debtor's chapter 13 proceedings claiming a violation of the Fair Debt Collection Practices Act. ("FDCPA"). The district court dismissed for failure to state a claim holding that filing an accurate claim on a time-barred debt does not implicate the FDCPA. The debtor then appealed.

The Eighth Circuit, on review, declined to follow the Eleventh Circuit in extending to bankruptcy claims the rule against actual or threatened litigation on time-barred debts. The Court held that the protections offered by the bankruptcy court satisfy the concerns of the FDCPA because the debtor is aided by the trustee, the process of objecting to a claim is less unnerving for a debtor than facing a collection lawsuit, and because the debtor has less at stake than a collection defendant.

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Ninth Circuit

Smith v. I.R.S. (In re Smith)
2016 WL 3749156, (9th Cir. 2016)

In *Smith*, the Ninth Circuit affirmed the district court in reversing the bankruptcy court and entering summary judgment in favor of the I.R.S. Smith failed to timely file his 2001 tax returns, and in 2006, the I.R.S. prepared a substitute for return ("SFR") and provided Smith with a notice of deficiency. Smith did not challenge the SFR and the I.R.S. subsequently assessed a deficiency of $70,662. In 2009, Smith filed a Form 1040 for the 2001 tax year which was intended to replace the SFR. Three years later, Smith filed bankruptcy and attempted to discharge the $70,662 assessment.

The Circuit held that the hanging paragraph of §523(a), which defines the term 'return' as "a return that satisfies the requirements of applicable non-bankruptcy law (including applicable filing requirements)," permits discharge of tax liability under §523(a)(1)(B) only if a Debtor has filed a "return" that satisfies the 4-factor test adopted by the Circuit in *In re Hatton*, 220 F.3d 1057, 1060 (9th Cir. 2000) (the document must (1) purport to be a return; (2) be executed under penalty of perjury; (3) contain sufficient data to allow calculation of tax; and (4) represent an honest and reasonable attempt to satisfy the requirements of the tax law).

The Ninth Circuit held that Smith did not satisfy the fourth factor of the *Hatton* test because Smith's "belated acceptance of responsibility" seven years after the return was due and three years after the I.R.S. assessment was not an "honest and reasonable attempt" to comply with the tax code. The Circuit however, did not decide the issue of whether any post-assessment filing could be "honest and reasonable."

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In The Matter Of Heller Ehrman, LLP, Debtor
2016 WL 4011194 (9th Cir. 2016)

In *Heller Ehrman, LLP v. Davis Wright Tremaine, LLP*, the Ninth Circuit panel certified the following question to the California Supreme Court:

> Under California law, does a dissolved law firm have a property interest in legal matters that are in progress but not completed at the time the law firm is dissolved, when the dissolved law firm had been retained to handle the matters on an hourly basis?

Although California courts of appeal have applied pre-1996 partnership law ("UPA") to address this issue, the Ninth Circuit court found no published California state court opinion addressing the issue after the legislature revised the partnership law ("RUPA").

In bankruptcy court, the plan administrator, on behalf of Heller, filed adversary proceedings against about fifty law firms, seeking to avoid the plan of dissolution's waiver of Heller's rights to post-dissolution legal fees under 11 U.S.C. § 548(a)(1)(B) or under California's Civil Code § 3439.05. Heller's argument was: (1) that it had a property right in legal fees generated by work on hourly matters after its dissolution; (2) that the waiver of this right in the dissolution agreement constituted a transfer of Heller's interest to former partners; and (3) that the new law firms were subsequent transferees of such transfers.

After the bankruptcy court denied the law firm defendants' motion to dismiss, Heller filed a motion for summary judgment against the remaining law firms (the appellees), who in turn, filed a cross-motions on whether the waiver in the plan of dissolution constituted a transfer of Heller's property to the law firm defendants and whether any such transfer was a fraudulent transfer under 11 U.S.C. § 548. Relying on its earlier decision in *In Brobeck, Phleger & Harrison LLP*, the bankruptcy court granted Heller's motion for summary judgment and certified to the district court that the case could proceed to bench and jury trials for calculating damages.

Rather than proceed to trial, the district court entered an order withdrawing the reference from the bankruptcy court; requested further briefing from the parties; and granted summary judgment in favor of the law firm defendants. The district court reasoned that RUPA undermines the foundation on which *Jewel v. Boxer* rests. Because *Jewel* does not apply, Heller did not have a property interest in its pending hourly matters at dissolution.

On appeal, Heller contended that the district court's reasoning was flawed: RUPA did not nullify the rule in *Jewel v. Boxer*, and under California law, a dissolved law firm has a property interest in the profits from the firm's unfinished business. Section 1601(h) of RUPA does not undermine *Jewel* because it only permits partners to receive *some* compensation for completing the dissolved law firm's unfinished business. To the extent that completion of the work generated profits beyond "reasonable compensation," former partners continue to have a fiduciary duty to account for profits to the former partnership. In essence, former partners continue to have a fiduciary duty to account for the legal fees generated from the pending hourly

matters when Heller dissolved, and most importantly, the dissolving firm continues to have a property in those fees.

The appellees, on the other hand, argued that former partners completing the dissolved firm's unfinished hourly matters are entitled to their hourly rate under section 1604(g) of RUPA and thus, Heller has no on-going property interest. Furthermore, the appellees argued, granting dissolved law firms a property interest in hourly matters that have been moved to law firms would discourage firms from representing clients of a dissolved firm because they would not profit from that representation.

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Tenth Circuit

Jester v. Wells Fargo Bank, N.A. (In re Jester)
No. 15-7079, 2016 WL 4039278 (10th Cir. July 25, 2016) (unpublished)

The Tenth Circuit affirmed the bankruptcy court's denial of a motion to reopen a chapter 7 bankruptcy case because the debtors had no claim against Wells Fargo for violating the automatic stay or the discharge injunction arising from a foreclosure lawsuit. Post-discharge, Mr. Jester entered into a loan modification agreement with Wells Fargo and, in turn, Wells Fargo dismissed its then-pending prepetition foreclosure suit. Mr. Jester failed to make payments causing Wells Fargo to file a new foreclosure action; it obtained summary judgment over Mr. Jester's objection. Mr. Jester moved the bankruptcy court to reopen his and his ex-wife's chapter 7 case to assert claims against Wells Fargo for violating the stay and discharge injunction by not dismissing the pre-petition foreclosure action and the post-discharge loan modification. The bankruptcy court denied the motion, concluding there was no violation of the stay or discharge injunction, and that it lacked subject matter jurisdiction to review the state court's ruling or otherwise grant the relief—holding Wells Fargo in contempt and assessing punitive damages—requested. The BAP affirmed. On further appeal, the Tenth Circuit concluded that the bankruptcy court did not abuse its discretion in denying the motion to reopen the debtors' chapter 7 case because Wells Fargo did not violate the stay or discharge injunction. The Tenth Circuit explained that there was no stay violation because, from and after the chapter 7 filing, Wells Fargo did not continue prosecuting the prior foreclosure action. The Tenth Circuit explained there was no violation of the discharge injunction "because the loan modification agreement was executed post-discharge and did not attempt to make the [debtors] personally liable for the discharged debt…." Finally, the Tenth Circuit upheld the bankruptcy court's conclusion it could not grant

the affirmative relief sought. The court explained that the failure of the debtors and Wells Fargo to reach a reaffirmation agreement had no effect on Wells Fargo's ability to foreclose independent of the loan modification, and in all events the claim that Wells Fargo breached the loan modification agreement or lacked standing to foreclose could not be reached due to the Rooker-Feldman doctrine. Under that doctrine, lower federal courts lack jurisdiction to review state court judgments or grant relief that would have the effect of overruling or unwinding such judgments.

Lee v. McCardle (In re Peeples)
No. 14-2159, 2016 WL 3947837 (Bankr. D. Utah July 14, 2016)

The bankruptcy court granted summary judgment for Defendant Scott McCardle in an action in which Plaintiffs (Mr. and Mrs. Lee), creditors of the debtors, asserted that McCardle violated the automatic stay by obtaining a judgment against Plaintiffs, that is, the stay subsumes actions by third parties against a debtor's creditor where the creditor sued the third party intending to recover a claim against the debtor. Plaintiffs had previously obtained judgments against the debtors; after deciding not to proceed with garnishment proceedings, Plaintiffs filed suit in state court against McCardle individually and as Trustee of his parents' trust principally relating to a modification of the trust that had the effect of eliminating beneficial interests of the grandchildren. McCardle obtained an order granting him summary judgment, dismissing the Lees' claims and awarding attorneys' fees; however, before final judgment was entered Mr. and Mrs. Peeples filed bankruptcy. Despite being advised of the bankruptcy filing, the state court entered final judgment for McCardle including awarding attorneys' fees. The Lees contend that the state action violated the stay in the Peeples' chapter 7 case and sought a declaratory judgment that the state court judgment was accordingly void *ab initio*. The bankruptcy court ruled for McCardle, explaining that the action didn't violate the stay because it was not against the debtors. The court construed the Lees' position to be that that the state action was stayed because Mr. Lee's intent was to recover against the debtors, and rejected it because nothing in Section 362 implicates a party's intent, relying on a prior decision, *In re Johnson*, 501 F.3d 1163 (10th Cir. 2007), noting a determination of whether an action violates the stay is made by reviewing "the objective nature of the action undertaken." Next, after acknowledging that a debtor need not necessarily have to be a party to an action for the stay to apply, the bankruptcy court explained that "an action against a non-debtor is not stayed simply because a creditor is attempting to recover a claim for which the debtor is liable." The court further explained that while an action is stayed if it is dependent upon a creditor's claim against the debtor, the stay does not apply if the basis for the claim is independent of the claim against the debtor, and the complaint at issue made it clear that the claims were against a non-debtor, McCardle.

***Klein v. Michelle Turpin & Assocs.*P.C.,**
No. 2:14-cv-302-RJS-PMW, 2016 WL 3661226 (D. Utah July 5, 2016)

The district court granted summary judgment for a Receiver of a single-member LLC operated as a Ponzi scheme on its fraudulent transfer claims—actual and constructive—against a law firm which provided tax-related services. The court's opinion focused on work the firm

performed in response to an IRS deficiency notice sent to the LLC's principal and his wife and fees associated with those services which resulted favorably for the principal and his wife. Initially, the court noted that "[a]s a single-member LLC, [the LLC] was disregarded by the IRS for income tax purposes" such that any income tax liability was a liability of the member, and while the IRS could issue a charging order as against the member's distributions it could not levy the LLC's assets to satisfy any tax liability of the member. The court first held that the Receiver possessed standing under an exception to the general rule that only creditors can bring fraudulent transfer claims in Ponzi scheme cases enunciated by the Seventh Circuit in *Scholes v. Lehman*, 56 F.3d 750 (7th Cir. 1995), which reasoned that the company has standing because, as a separate legal entity, it too was harmed by the scheme. The court expressly rejected the argument that the Receiver's standing was limited to payments made in furtherance of the Ponzi scheme, relying on *Klein v. Cornelius*, 786 F.3d 1310 (10th Cir. 2015). Next, the court concluded that actual intent to hinder, delay or defraud was properly inferred because the LLC was operated as a Ponzi scheme, and rejected the argument that the Ponzi scheme presumption was limited to payments in furtherance of the scheme or to investors or for referral fees, stating that binding case law provided no support for such a limitation. Regarding the reasonably equivalent value defense to the Receiver's actual fraud claim, the district court concluded that the law firm did not provide value to the LLC because any tax liability flowed to the LLC's single member such that the services rendered brought value to the member, not the LLC. Accordingly, there was no need to determine if the value was "reasonably equivalent" to the fees paid to the law firm. The court rejected as speculative the firm's contention that it preserved the receivership estate because the member would have paid the firm's fees from the LLC's assets. The court rejected the related argument that the LLC was contractually obligated to pay the firm's fees, accepting evidence that the member—not the LLC—contracted with the firm. Finally, the court found for the Receiver on his constructive fraud claims, reiterating the absence of a contractual relationship between the LLC and the law firm precluding the existence of antecedent debt satisfaction of which would establish reasonably equivalent value, and the fact that the LLC was insolvent prior to the payment at issue.

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<u>Eleventh Circuit</u>

Soderstrom v. J. Thompson Investments, LLC (In re Soderstrom)
No. 15-14922, 2016 WL 3611542 (11th Cir. July 6, 2016).

The Appellant, a debtor/defendant in a non-dischargeability proceeding under § 523(a)(2)(A) of the Bankruptcy Code, appealed the bankruptcy court's judgment which found that the Appellee obtained the Appellant's $811,000 investment in a real estate venture through fraudulent misrepresentation. The Eleventh Circuit affirmed the judgment, finding (1) the bankruptcy court's credibility determination in the "he-said, she said" dispute in favor of the Appellee was not clear error; (2) the Appellee's reliance on the Appellant's stated use of the funds was justifiably reasonable; and (3) the bankruptcy court did not err in finding that the Appellee's reliance proximately caused her loss—the Appellee credibly testified she would not have invested if she knew the Appellant was going to use her investment to "cash out" of the business.

Fla. Agency for Health Care Admin. v. Bayou Shores SNF, LLC,
(In re Bayou Shores SNF, LLC)
No. 15-13731, 2016 WL 3675462 (11th Cir. July 11, 2016).

The Appellee, Bayou Shores SNF, LLC, filed a chapter 11 bankruptcy petition after its Medicare and Medicaid provider agreements were terminated by the Florida Agency for Health Care Administration ("ACHA") and the United States Department of Health and Human Services ("HHS") for alleged deficiencies. Bayou Shores sought relief in federal district court, but the court determined Bayou Shores failed to exhaust administrative remedies required by 42 U.S.C. § 405(h); therefore the district court lacked jurisdiction over the provider agreements. Bayou Shores then filed a chapter 11 bankruptcy petition. In bankruptcy court, Bayou Shores immediately sought and received a preliminary injunction preventing the agencies from terminating the provider agreements.

In the bankruptcy proceeding, the court found that the provider agreements were property of the bankruptcy estate and, based on the plain language of § 405(h), bankruptcy court jurisdiction under 28 U.S.C. § 1334 was not precluded in the same manner as district court jurisdiction. The court confirmed the debtor's chapter 11 plan with the confirmation order providing for the assumption of the provider agreements. ACHA and HHS appealed the confirmation order and the district court reversed, holding that § 1334's absence in § 405(h) was the result of a codification error. The Eleventh Circuit affirmed the district court, reaching the same conclusion based on a lengthy analysis of legislative history. The appeals court also rejected Bayou Shores' claim that the appeal was equitably moot.

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