Bankruptcy Circuit Update

Featuring cases from May 2016

Supreme Court

***Husky Int'l Elec., Inc. v. Ritz*,**
136 S. Ct. 1581 (2016)

In the Supreme Court's first decision this term dealing with the Bankruptcy Code, the Court determined by a 8-1 majority that the term "actual fraud" under § 523(a)(2)(A) could encompass fraudulent transfers even though the debtor did not make a false representation to a creditor. In ***Husky***, the petitioner had sold electronic devices to Chrysalis Manufacturing Corp. The respondent, Ritz, served on Chrysalis's board and owned 30 percent of the common stock of Chrysalis. Rather than pay Husky for the purchase of the electronic devices, Ritz through Chrysalis, diverted monies from Chrysalis to other entities that Ritz controlled. Husky sued Ritz in state court under Texas state law alleging that the transfers to the other entities constituted "actual fraud." Ritz filed for chapter 7 bankruptcy and Husky filed a § 523(a)(2)(A) complaint alleging that the transfers were debts obtained by actual fraud under § 523(a)(2)(A). Section 523(a)(2)(A) provides that a debt is not discharged to the extent it was obtained by a false representation or actual fraud. The bankruptcy court concluded that because Ritz made no misrepresentation to Husky there could be no actual fraud. The district court affirmed, finding that Ritz was personally liable for the debt, but that the debt was dischargeable because the debt was not obtained by actual fraud. The Fifth Circuit also affirmed, holding that a misrepresentation from a debtor to a creditor is a necessary element to actual fraud. The Fifth Circuit found that there was no evidence of Ritz making any false representations to Husky regarding the fraudulent transfers.

The Supreme Court reversed, noting that actual fraud can encompass fraudulent conveyance schemes without a false representation. The Court found that, under the Statute of 13 Elizabeth and subsequent English bankruptcy practice, courts and legislatures have used the term "fraud" to include a debtor's transfer of assets that impairs a creditor's ability to collect on a debt. As to the necessity of the debtor making a false representation for there to be actual fraud, the Court found that, under the same Statute of 13 Elizabeth and the laws that followed, the debtor and the recipient of the conveyed assets were liable for fraud even though the recipient of the fraudulent conveyance made no representation to the debtor's creditors. The Court further recognized that the transferor in this case did not obtain a debt as part of the fraudulent conveyance. Nonetheless, the Court found that the recipient of the transfer can commit fraud by obtaining the assets through participating in the fraud. As a result, the recipient who later filed for bankruptcy might be subject to a dischargeability action under § 523(a)(2)(A) for a debt "obtained by" a fraudulent conveyance. Justice Thomas dissented, noting that the Court's ruling impermissibly extended beyond what Congress intended "actual fraud" to be under § 523(a)(2)(A) by including fraudulent transfers.

Submitted by:
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Second Circuit

***Gissin v. Freedman, Moore Capital Mgmt., LLC*,**
2016 WL 2865616 (2d Cir. May 17, 2016)

The Second Circuit affirmed the judgment of the district court holding that a foreign bankruptcy proceeding is within the scope of 28 U.S.C. § 1782(a), which allows district courts to issue orders authorizing parties to take discovery in the United States "for use in a proceeding in a foreign or international tribunal."

On appeal, the only argument put forward by appellants was that the discovery sought was not "for use" in a foreign proceeding, and thus did not fall within the parameters of § 1782. The Second Circuit agreed with the district court in holding that *Lancaster Factoring Co. v. Mangone*, 90 F.3d 38, 42 (2d Cir. 1996), controlled the outcome here. In that case, the Second Circuit held that a foreign bankruptcy proceeding "is within the intended scope of § 1782," rejecting the respondent's argument that the discovery was not for use in a foreign proceeding "because Lancaster may or may not exercise its option to acquire whatever claims it may find and may or may not decide to commence a proceeding to pursue those claims." The Second Circuit found that this uncertainty was not dispositive, because regardless of what may occur in the future, there already was a pending foreign bankruptcy proceeding. The Second Circuit also supported its holding by citing to *In re Application of Hill*, No. M19-117(RJH), 2005 WL 1330769, at * 5 (S.D.N.Y. June 3, 2005), where the court granted a § 1782 petition filed by a liquidator in a Hong Kong liquidation proceeding, noting that the fact that the liquidator "may use the fruits of discovery to pursue potential claims against third parties does not undermine their equally legitimate goals of reconstructing financial records, evaluating key transactions and identifying and recovering the debtors' assets."

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Third Circuit

In re Net Pay Solutions, Inc.,
2016 WL 2731676, (3d Cir. May 10, 2016)

In a case of first impression, the Third Circuit affirmed the district court and held that for purposes of determining whether a debtor's pre-bankruptcy transfer meets the preferential transfer threshold—currently set at $5,850 under 11 U.S.C. § 547 (c)(9)—multiple transfers cannot be aggregated to meet the threshold, unless these transfers are "transactionally related to

the same debt." The Chapter 7 trustee argued that four transfers—each of which did not individually meet the $5,850 threshold—from the debtor, Net Pay Solutions, to the IRS made less than three months prior to the bankruptcy filing should be returned to the estate because the transfers violated 11 U.S.C. § 547(b).

The Third Circuit found that each of the four transfers constituted payment of outstanding payroll taxes on behalf of five separate Net Pay Solutions clients to the IRS. As a result, the Third Circuit held the four transfers that did not each independently meet the $5,850 threshold could not be considered in the aggregate to exceed the threshold because each transaction dealt with a separate client, and therefore a separate debt. As for a fifth transfer—a transfer that on its own did exceed the $5,850 threshold—the Third Circuit held that this transfer could not be returned to the estate because the funds in the transfer were outstanding taxes owed to the IRS, and thus Net Pay Solutions never owned the funds. The funds were held in trust for the United States under 26 U.S.C. § 7501(a) from the moment Net Pay Solutions withheld the funds from its clients.

In re Energy Future Holdings Corp.,
2016 WL 2343322, (3d Cir. May 4, 2016)

In affirming the district court, the Third Circuit held that the bankruptcy court did not err in approving a Chapter 11 debtor and noteholders first lien settlement. After filing for bankruptcy, the debtor made a "tender offer" to the first lien noteholders in which the debtor offered to pay each first lien noteholder the full principal amount of the note, as well as accrued interest, in exchange for "the release of any potential claim to the make-whole premium." The "make-whole premium" included in the notes provided compensation to noteholders for any lost future interest should the debtor redeem the notes before the final maturity date. The debtor moved to approve the settlement, but the trustee—on behalf of those lien holders that chose not to take part in the settlement—objected to the motion to approve, claiming that the settlement did not treat all creditors equally.

The Third Circuit found that the equal treatment rule and the absolute priority rule apply in the plan confirmation process, but are "not categorically applied" in pre-confirmation settlements. Rather, the Third Circuit held that the bankruptcy court may use a flexible approach in approving settlements as long as the court "ensures the evenhanded and predictable treatment of creditors." The Third Circuit found that because the settlement saved the estate millions of dollars each month, and all creditors were given the opportunity to participate in the settlement, the approval of the settlement was appropriate, did not harm other creditors, and was consistent with the equal treatment rule. Further, the Third Circuit found nothing in the Bankruptcy Code that prohibits the use of a "tender offer" to communicate a settlement.

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Fourth Circuit

***Sheehan v. Saoud* (*In re AGS, Inc.*),**
2016 WL 2990988 (4th Cir. May 24, 2016):

On May 24, 2016, the Fourth Circuit affirmed the decision of the U.S. District Court for the Northern District of West Virginia, which dismissed claims by a chapter 7 trustee arising from, and related to, alleged fraudulent transfers. The debtor had operated as a health care company and, prepetition, was sold by its former owner to an existing employee.

Initially, the chapter 7 trustee filed a six count complaint with the district court, seeking a jury trial, and averring fraudulent transfer claims under the Bankruptcy Code, the West Virginia Uniform Fraudulent Transfer Act (the "*WVUFTA*"), and common law claims for aiding and abetting and civil conspiracy. The complaint named as defendants the debtor's former owner, as well as other individuals and a corporate entity that were the recipients of the transfers.

After an adverse summary judgment ruling, the chapter 7 trustee abandoned the relevant bankruptcy-specific claims. Ultimately, the only questions submitted to the jury sounded in West Virginia law and pertained to the applicable statutes of limitation and repose. The jury found that the chapter 7 trustee did not file suit timely, which the district court judge affirmed.

On appeal to the Fourth Circuit, the chapter 7 trustee sought review as to three issues: (i) the tolling of the applicable statute of limitation, (ii) the application of the statute of repose; and (iii) the application of a civil conspiracy claim predicated on a violation of the *WVUFTA*. The Fourth Circuit affirmed the district court's ruling, holding that: (a) the first issue was not properly preserved on appeal; (b) the statute of repose expired on year before the chapter 7 trustee filed suit on the *WVUFTA* claim; and (c) the chapter 7 trustee failed to please adequately the civil conspiracy claim. The Fourth Circuit concluded that the claims were barred and affirmed the district's dismissal of those claims.

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Fifth Circuit

Matter of Pirani.,
2016 WL 3063261 (5th Cir. May 27, 2016)

Two brothers and three investors personally guaranteed a $2.5 million debt to One World Bank. The parties had a falling out and the investors sued the brothers in state court. As part of their settlement, the brothers agreed that they would buy back the investor's interests and the investors would be released from their personal guarantees on the $2.5 million debt. The brothers' entity eventually defaulted on the One World Bank note, and One World Bank sued each of the guarantors—including the investors. The investors filed cross claims against the brother's entity asserting they breached their original settlement agreement by: (1) failing to buy back membership interests (the "payment claim"); (2) failing to secure the release of the investors from the guaranty agreement (the "release claim"); and (3) defaulting on the note itself. As part of a settlement with the brothers, One World Bank assigned the note, guaranty agreement, and all of its claims against the investors to one of the brothers, Pirani. The state court granted summary judgment in favor of the investors on the payment claim and severed that claim. Eventually, the state court entered a final agreement judgment in favor of the investors. Pirani then filed bankruptcy and the investors filed a proof of claim based on the final agreement judgment. Pirani then initiated an adversary against the investors based on the guaranty agreement that One World Bank assigned to him. The investors counter claimed asserting their release claim. Pirani argued that the claim was barred by res judicata, which the bankruptcy court and district court rejected. Applying Texas claim preclusion, or res judicata, the Fifth Circuit noted that normally all claims arising from a legal relationship, like a contract or lease, are subject to res judicata. Nonetheless, where a claim is specifically severed by the trial court, res judicata does not bar it. Therefore, the investors' release claim was not barred.

Additionally, Pirani disagreed with the bankruptcy court's dismissal of Pirani's breach of guaranty claim on the grounds that Pirani should not be permitted to sue the defendants for breach of guaranty agreement from which he had promised to have them released. Under Texas law, the right to sue as an assignee on the note and guaranty agreement is limited as a matter of law to the contributive shares of its co-guarantors. Pirani took the position as assignee of the One World Bank Note; he is suing not as a co-guarantor and thus can recover the full amount, not just the contributive shares paid. The Fifth Circuit rejected this argument finding that the assignment of an underlying note and guaranty agreement to a guarantor does not change the status of the guarantor in relation to his co-guarantors.

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Ninth Circuit

In *Castaic Partners LLC, et al. v. DACA-Castaic, LLC*
(In the Matter of Castaic Partners II, LLC),
2016 WL 2957150 (9th Cir. May 23, 2016)

The Ninth Circuit affirmed a district court's dismissal of the debtors' appeal of an order granting a creditor stay relief to foreclose on real property where, during the appeal, the property was sold and the bankruptcy court subsequently dismissed the debtors' bankruptcy cases without appeal by the debtors which rendered the appeal constitutionally moot. The Ninth Circuit relied on a factually similar case from the Eight Circuit, *Olive St. Inv. v. Howard Sav. Bank*, 972 F.2d 214 (8th Cir. 1992). In *Castaic*, as a result of the debtors' failure to appeal the order granting the creditor-appellee stay relief that court "'no longer had power to order [a] stay or to award damages allegedly attributable to its vacation.'" Slip Op. at 7 (quoting *Armel Laminates, Inc. v. Lomas & Nettleton Co. (In re Income Prop. Builders, Inc.*), 699 F.2d 963, 964 (9th Cir. 1982) (per curiam). The Ninth Circuit noted that dismissal of the debtors' bankruptcy cases was permissible notwithstanding their appeal of the stay relief order because the filing of the notice of appeal did not divest the bankruptcy court of jurisdiction over matters or issues not subject to the appeal. Slip Op. at 7, n.3. The Ninth Circuit explained that, "[a]bsent an appeal from the dismissal orders, we have no power to restore the bankruptcy proceeding," *id.* at 8, which rendered the appeal constitutionally moot, *i.e.*, the lack of a "case or controversy" under Article III of the Constitution.

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Kirkland v. Rund (In re Matter of EPD Investment Company, LLC),
2016 WL 2620300 (9th Cir. May 9, 2016)

In *Kirkland v. Rund*, the Ninth Circuit affirmed the district court's decision affirming the bankruptcy court's denial of a motion to compel arbitration in connection with a trustee's adversary proceeding to avoid fraudulent transfers. As an initial matter, "in a core [bankruptcy] proceeding . . . a bankruptcy has discretion to decline to enforce an otherwise applicable arbitration provision only if arbitration would conflict with the underlying purposes of the Bankruptcy Code." *Continental Insurance Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011, 1021 (9th Cir. 2012) (internal cites omitted). "When a bankruptcy court considers conflicting policies . . . , [the circuit] acknowledge[s] its exercise of discretion and defer its determinations that arbitration will jeopardize a core bankruptcy proceeding." *Ackerman v. Eber (In re Eber)*, 687 F.3d 1123, 1131 (9th Cir. 2012).

Relying on its prior decision in *In re Bellingham*, the Court outright rejected the appellees' argument that the trustee's claims were the constitutional equivalent of non-core claims because the appellees had requests a jury trial and not consented to one before the bankruptcy court. *See Exec. Benefits Ins. Agency v. Arkison (In re Bellingham Ins. Agency, Inc.)*, 702 F.3d 553 (9th Cir. 2012). As such, the Court held that the bankruptcy court correctly found the trustee's fraudulent conveyance, subordination, and disallowance causes of actions to be core proceedings and thereby, giving it discretion to evaluate the bankruptcy and arbitration interests at issue.

The Court then held that the bankruptcy court properly applied the *Thorpe* analysis to determine that the arbitration provisions at issue conflicted with Bankruptcy Code purposes of having bankruptcy law issues decided by bankruptcy courts; of centralizing resolution of bankruptcy disputes; and protecting parties from piecemeal litigation.

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10th Circuit

***In re Lane*,**
2016 WL 2641238, (10th Cir. May 10, 2016)

The Tenth Circuit, in affirming the district court, held that a debtor who waives his standing to interfere further with the administration of his bankruptcy case cannot object to a proof of claim after the debtor waived his standing. The debtor and his ex-wife entered into a divorce settlement in which the debtor agreed that he "shall not have any standing to object, join, or otherwise be heard on any matter or proceeding in any pending or future matter in connection with administering his case." Shortly after both parties consented to the agreement the debtor objected to the proof of claim, but asserted that he was not claiming standing.

The Tenth Circuit found that when a debtor "intentionally relinquished, abandoned, or conceded" an issue in the bankruptcy court—or other trial court—that right is considered waived and not available for consideration on appeal. Because the debtor conceded his standing as part of his settlement agreement in the bankruptcy court, the Tenth Circuit found he has no standing to appeal those proceedings, and affirmed the district court's dismissal of the debtor's appeal from the bankruptcy court for lack of standing.

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