

Bankruptcy Circuit Update
Featuring cases from May 2017

Supreme Court

***Midland Funding, LLC v. Johnson*, No. 16-348, 2017 WL 2039159 (S. Ct. May 15, 2017)**

In *Midland Funding* the Court considered whether the filing of a time barred proof of claim is a false, deceptive, or misleading debt collection practice under the Fair Debt Collection Practices Act (FDCPA). In a 5-3 decision reversing the Eleventh Circuit, Justice Breyer found that the filing of a proof of claim that was time barred under an applicable Alabama statute of limitations did not violate the FDCPA because the Bankruptcy Code does not require that a filed proof of claim be an “enforceable” claim. Justice Sotomayor dissented, along with Justices Kagan and Ginsburg. Newly appointed Justice Gorsuch did not participate in the hearing or decision.

The underlying facts of this case mirror those of many chapter 13 cases. The debtor-respondent, Aleida Johnson, filed a chapter 13 case in the S.D. Alabama bankruptcy court. Petitioner Midland Funding, LLC, filed a proof of claim indicating a credit card debt for \$1,879.71. The last charge on the account was in May 2003, more than 10 years before the debtor filed her chapter 13 case. The relevant Alabama statute of limitations for collection on a debt is six years. Respondent objected to the proof of claim alleging limitations. The petitioner did not respond, and, as such, the bankruptcy court disallowed the claim.

Johnson filed a lawsuit in district court seeking actual damages, statutory damages, attorney’s fees, and costs for violations under the FDCPA. The district court found that the FDCPA did not apply and dismissed the case. The Eleventh Circuit disagreed, finding that the respondent’s conduct was “false, deceptive, misleading, unconscionable, or unfair” under the FDCPA and reversed the district court.

The Court agreed with the majority of the Court of Appeals, finding that the filing of a proof of claim that on its face indicates that the statute of limitations has run does not constitute “false, deceptive, misleading, unconscionable, or unfair” conduct under the FDCPA. The Court found that, because “claim” as defined under 11 U.S.C. § 101(5)(A) is defined as a right to payment, and, under applicable Alabama law a creditor has the right to payment of a debt even after the expiration of the statute of limitations; that seeking payment of a stale claim does not violate the FDCPA. The respondent argued that the word “claim” in the bankruptcy context means “an enforceable obligation” as previously defined by the Court in *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552, 559 (1990). The Court disagreed, noting that the word “enforceable” does not appear in the Code and that the Court used the word “enforceable” descriptively in *Davenport*.

The Court then analyzed the issue of whether the known assertion of a barred claim is unfair or unconscionable under the FDCPA. The court found the lower court opinions that have found that it is have not examined the issue in the context of a chapter 13 case. The Court reasoned that, while a consumer might unwittingly pay a stale debt outside of bankruptcy that possibility is limited because there is a claims allowance process in bankruptcy and that the chapter 13 trustee

will most likely object to a stale claim. Moreover, the Court noted that such a practice of filing a stale claim is not necessarily sanctionable because untimeliness in bankruptcy is an affirmative defense, thereby protecting the debtor from paying stale claims. Further, the Court stated that the chapter 13 trustee bears the burden of investigating claims and raising limitations in claims objections. These protections do not exist outside of bankruptcy.

The dissenting Justices disagreed with the Court's holding, noting that the Court's ruling condones a practice that was recently the subject of a consent decree barring such conduct and awarding victims restitution of \$34 million. Justice Sotomayor argued that this decision would encourage debt buyers to file stale claims in the hope that they get undiscovered and paid in bankruptcy cases.

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First Circuit

In re Guzman (Guzman v. Rentas), Case No. 13-04232, BAP No. PR 16-045 (1st Cir. BAP, May 17, 2017)

In *Guzman*, the Bankruptcy Appellate Panel ("BAP") for the First Circuit considered an appeal denying the Debtors' motion for reconsideration sustaining the chapter 7 Trustee's objection to certain claimed exemptions. In brief, after the Debtors' case was converted from chapter 11 to chapter 7, they amended their claimed exemptions to include funds that had been held in the debtor-in-possession account ("DIP account") ("Second Amendment"). The Trustee objected to the Debtors exempting their DIP account; however the notice provision incorrectly advised parties that they had a 30-day period to object, rather than a 14 day period under the local bankruptcy rules. The Court entered an order sustaining the Trustee's objection, which it later vacated after the Debtors filed their first motion for reconsideration. Months later, the Debtor filed its fourth amendment to its exemption schedules to include an apartment they owned ("Fourth Amendment"). The Trustee filed her second objection rearguing that the Debtors were not entitled to exempt their DIP account, but once again the notice provision was incorrect. The Debtors did not file a timely objection. The Court sustained the Trustee's objection and subsequently denied the Debtors' second reconsideration motion. The Debtor appealed the denial of its second reconsideration motion.

First, the Debtor argued that the Trustee's notice was misleading. The BAP affirmed the Bankruptcy Court and held that the Debtors had prior knowledge of the correct response period by virtue of the earlier proceedings relating to the Trustee's objection to the Second Amendment. Additionally, the docket entry for the Trustee's objection identified the correct 14 day response deadline. Second, the Debtors argued that the Trustee's objection to their DIP account exemption was time barred under Rule 4003(b)(1) of the Federal Rules of Bankruptcy Procedure. Rule 4003(b)(1) provides that a party in interest may file an objection to the list of property claimed as exempt within 30 days after the 341(a) meeting of creditors is concluded or

“within 30 days after any amendment to the list or supplemental schedules is filed, whichever is later.” The Trustee argued that each amendment to a debtor’s exemptions starts a new 30-day objection period for any exemption listed, regardless of whether or not a particular claimed exemption was actually added or modified by the amended schedules. Thus, the Trustee could object to the Debtors exempting their DIP account through the Fourth Amendment even though the Debtors previously claimed that exemption in their Second Amendment. The Debtor argued a narrower approach, asserting that an amendment starts a new objection period only for those specific exemptions that were added or amended. The BAP noted that the First Circuit has not addressed this precise issue and the courts are divided. The majority of courts take the Debtors’ position that the filing of an amendment does not reopen the time to object to original exemptions not affected by the amendment. The rationale behind this conclusion is the need for prompt action and finality. Other courts look to the plain language of Rule 4003(b)(1) and opine that a party in interest may object to any claimed exemption even if the challenged exemption was not itself the subject of the amendment. The BAP sidestepped this precise issue and held that the Bankruptcy Court’s adoption of the Trustee’s position was not a “plain and indisputable error that amounted to a complete disregard of controlling law.” (Internal quotations omitted).

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Second Circuit

In re Lehman Bros. Holdings Inc. (Adler v. Lehman Bros. Holdings Inc.) 16-1296, 16-1304, 16-1306, 16-1360, 16-1361, 16-1363, 16-1365, 16-1367, 855 F.3d 459, (2d Cir., May 4, 2017)

In this case, which arose from the 2008 bankruptcy filing by Lehman Brothers Holdings Inc. (“Lehman Brothers”), the Second Circuit affirmed the judgment of the district court affirming the bankruptcy court’s judgment subordinating the claims of holders of restricted stock units (“RSUs”). The Second Circuit held that the claims at issue must be subordinated pursuant to Bankruptcy Code section 510(b) because (1) RSUs are securities, (2) the claimants acquired them in a purchase, and (3) the claims for damages arise from that purchase or the asserted rescission thereof.

When Lehman Brothers filed for Chapter 11 bankruptcy on September 15, 2008, thousands of its employees held RSUs, i.e. compensatory awards that gave employees a contingent right to own Lehman Brothers common stock at the conclusion of a five-year holding period. Because these had been awarded between 2003 and 2008, the employees holding them at the time Lehman Brothers filed for Chapter 11 did not receive common stock. The filing effectively rendered their restricted stock units worthless.

Many of the affected employees filed proofs of claim in the bankruptcy proceeding seeking cash payments in amounts reflecting the face value of the restricted stock units. In response, Lehman

Brothers filed fourteen omnibus objections seeking to reclassify over 3,000 RSU-based claims as equity interests and to subordinate them to the claims of general creditors. The bankruptcy court sustained the objections on the ground that the claims must be subordinated to the claims of general creditors pursuant to Bankruptcy Code section 510(b) because the former arose from the purchase or sale of securities. Alternatively, the bankruptcy court held that because an RSU is an “equity security” (as defined in Bankruptcy Code section 101(16)), the employees’ claims were disallowed insofar as the claimants, as equity security holders, were only able to assert proofs of interest, not proofs of claim. The district court affirmed on both grounds, and the claimants appealed.

Preliminarily, the Second Circuit noted that it need not address the issue of whether an RSU is an “equity security” pursuant to Bankruptcy Code section 101(16), because RSU holders would still not be barred from asserting proofs of claim—such as the breach-of-contract claims asserted in this case in connection with the RSUs.

The Second Circuit then turned to the subordination issue, noting that Bankruptcy Code section 510(b) is to be construed broadly because it safeguards the absolute priority rule, a bedrock principle of bankruptcy law, under which creditors are entitled to be paid ahead of shareholders in the distribution of corporate assets. Accordingly, the Second Circuit noted that the claims at issue in this case must be subordinated pursuant to section 510(b) if each of the following three conditions is met: (1) the RSUs are securities, (2) the claimants acquired them in a purchase, and (3) the claims for damages arise from that purchase or the asserted rescission of it.

Turning to the first prong, the Second Circuit held that the RSUs qualify as securities pursuant to Bankruptcy Code section 101(49)(A)(xiv), which is a residual clause that covers any “other claim or interest commonly known as ‘security.’” The Second Circuit reasoned that the RSUs bear many of the hallmark characteristics of a security, because, like many security holders, the RSU holders had limited voting rights and received any declared dividends in the form of additional RSUs. More importantly, the Second Circuit noted that holders of RSUs faced the same risk and benefit expectations as shareholders because the value of their RSUs was tied to the value of Lehman Brothers’ common stock. Accordingly, the Second Circuit held that the claimants’ RSUs are securities within the meaning of Bankruptcy Code section 510(b) because they meet the definition of that term set forth in Bankruptcy Code section 101(49)(xiv) insofar as they bear hallmarks of interests commonly known as securities.

The Second Circuit then turned to the second prong of the analysis and addressed whether the claimants received the RSUs through a “purchase or sale.” The Second Circuit noted that the term “purchase” in Bankruptcy Code section 510(b) should be construed broadly to include circumstances where a claimant has received equity securities in exchange for labor. Here, the Second Circuit reasoned that the claimants “purchased” the RSUs within the meaning of Bankruptcy Code section 510(b) by agreeing to receive them, in lieu of cash, in exchange for a portion of their labor.

Finally, the Second Circuit turned to the third prong and addressed whether the claims at issue were claims for damages arising from the purchase of a security pursuant to Bankruptcy Code section 510(b). The Second Circuit began this analysis by noting that Bankruptcy Code section

510(b) provides that claims “arising from” a securities transaction must be subordinated, and this provision is to be interpreted broadly. In other words, a claim (no matter how it is characterized by the claimant) should be deemed to have arisen from a securities transaction so long as the transaction is part of the causal link leading to the alleged injury. Accordingly, the Second Circuit noted that it believed Bankruptcy Code section 510(b) should apply to all claims asserted in this case because they would not have arisen but for the claimants’ agreement with Lehman Brothers to receive part of their compensation in the form of RSUs.

The Second Circuit then considered a variety of theories proffered by the claimants in opposition to this conclusion and found none to be persuasive. In this analysis, the Second Circuit focused on the terms of the documents governing the RSU program, finding that the claimants’ assertion of alternative-performance claims against Lehman Brothers had no support in the documents, which provided that Lehman Brothers’ only obligation to holders of unvested RSUs was to deliver the stock at the conclusion of the five-year period. The Second Circuit also found the claimants’ restitution argument to be unavailing, noting that although the claimants were theoretically wronged by not receiving the Lehman Brothers shares they were owed, those shares became worthless once Lehman Brothers filed for bankruptcy. Accordingly, the claimants suffered no actual injury because the only thing to which they were contractually entitled—shares of Lehman Brothers common stock—had no value. The Second Circuit therefore affirmed the judgment of the district court.

In re Fairfield Sentry Ltd (Farnum Place, LLC v. Krys), 16-2127, 2017 WL 2258282 (2d Cir., May 22, 2017)

In a Chapter 15 case on remand, the Second Circuit affirmed the judgment of the district court affirming the bankruptcy court’s decision to disapprove of the sale of Fairfield Sentry Limited’s (the “Debtor”) claim in liquidation of Bernard L. Madoff Investment Securities LLC (“BLMIS”) the duly appointed liquidator in and recognized foreign representative of (the “Foreign Representative”) the Debtor’s British Virgin Islands (“BVI”) liquidation, to Farnum Place, LLC (“Farnum”). On remand, the Second Circuit had ordered the bankruptcy court to apply Bankruptcy Code section 363(b) to the proposed sale.

When this case was originally before the Second Circuit (“Sentry I”), the Second Circuit considered the Foreign Representative’s appeal from the affirmance of a bankruptcy order concluding that the property to be sold was not “within the territorial jurisdiction of the United States” within the meaning of Bankruptcy Code section 1520(a)(2), which otherwise would have required review of the sale pursuant to Bankruptcy Code section 363 to determine whether there was a “good business reason” to approve it. The bankruptcy court had also held, in the alternative, that “comity dictate[d] deference to [the BVI] Court’s judgment approving the sale.”

In Sentry I, the Second Circuit focused on whether the bankruptcy court was required to consider a review under Bankruptcy Code section 363 and ultimately held that it was required because the sale property was within the territorial jurisdiction of the United States. The Second Circuit also rejected the bankruptcy court’s alternative holding regarding comity. While acknowledging the centrality of comity to Chapter 15, the Second Circuit observed that Bankruptcy Code section 1520(a)(2)’s requirement of Bankruptcy Code section 363(b) review operated as a limitation on

comity, noting that Bankruptcy Code section 1520(a)(2) expressly provides that Bankruptcy Code section 363 must apply “to the same extent” as it would to the property of a domestic bankruptcy estate, and that “it is not apparent at all that the BVI Court even expects or desires deference in this instance.” Accordingly, the Second Circuit remanded the case to the district court with specific “instructions to [remand] to the bankruptcy court for such [§ 363(b)] review.”

On appeal, Farnum argued against the district court’s later decision to disapprove of the transaction based on its determination that the Foreign Representative had provided a “sound business reason” for disapproval, asserting two primary arguments: (1) that the bankruptcy court erred in disapproving the sale in 2015 because its issuance of a 2010 order “entrusting the administration or realization of all or part of the debtor’s assets within the territorial jurisdiction of the United States to the foreign representative,” satisfied the notice-and-hearing requirement of Bankruptcy Code section 363(b) imposed upon the sale by operation of Bankruptcy Code section 1520(a)(2) (the “Entrustment Argument”); and (2) that the bankruptcy court gave insufficient weight in its section 363(b) analysis to comity values (the “Comity Argument”). The Second Circuit addressed each of these arguments in turn, but ultimately held that such arguments were foreclosed by Sentry I’s mandate; the mandate rule generally “compels compliance on remand with the dictates of the superior court and forecloses relitigation of issues expressly or impliedly decided by the appellate court.”

Turning first to the Entrustment Argument, the Second Circuit noted that upon deciding that the sale property was within the territorial jurisdiction of the United States within the meaning of Bankruptcy Code section 1520(a)(2), Sentry I held that the bankruptcy court was to conduct a section 363(b) review. In so holding, the Second Circuit necessarily concluded that the bankruptcy court’s initial section 1521(a)(5) entrustment order—issued when the Foreign Representative first sought Chapter 15 recognition of the BVI liquidation in 2010—did not satisfy section 363(b), as Farnum now argued, because, otherwise, the Second Circuit would not have instructed the bankruptcy court to consider all relevant section 363(b) factors on remand. The Sentry I panel was thus presented with the argument that further section 363(b) review was unnecessary but, nonetheless, directed that such review go forward. Accordingly, the Second Circuit noted that Sentry I’s mandate thus both impliedly rejected the Entrustment Argument and limited the lower courts’ consideration on remand to a traditional section 363(b) analysis.

The Second Circuit then turned to the Comity Argument, noting that Sentry I explicitly rejected the notion that comity values underlying Chapter 15 compelled deference to the BVI court’s approval of the sale to the exclusion of any section 363(b) review. Because Farnum presented essentially the same argument on appeal, the Second Circuit held that it was barred by the mandate.

Alternatively, Farnum requested that the Second Circuit reconsider its earlier ruling for “cogent or compelling reasons” consistent with the law-of-the-case doctrine. The Second Circuit noted that reconsideration may be justified when there is “the need to correct a clear error or prevent manifest injustice.” The Second Circuit found no clear error in its prior holdings regarding either the Entrustment or Comity Arguments, and therefore declined to reconsider its earlier decision. Accordingly, the Second Circuit affirmed the judgment of the district court.

***In re Ampal-Am. Isr. Corp. (Maiman v. Spizz)*, 16-2855, 2017 WL 2274279 (2d Cir., May 24, 2017)**

In a case centering on the dispute between the Chapter 7 Trustee (the “Trustee”) of Debtor Ampal-American Israel Corporation (“Ampal”) and Ampal’s controlling shareholders, led by Ampal’s former chief executive officer, chairman, and president and an entity under his control, Merhav (M.N.F.) Limited (collectively, “Maiman”), the Second Circuit affirmed the judgment of the district court affirming the bankruptcy court’s order approving the retention of Tarter, Krinsky & Drogin LLP (“TKD”) as substitute general bankruptcy counsel.

In 2012, Ampal filed a Chapter 11 petition which was subsequently converted to a Chapter 7 proceeding. Following the appointment of the Trustee in 2013, the Trustee retained his law firm (“Spizz Cohen”) as general bankruptcy counsel. Over the next two years, various disputes arose between Maiman and Ampal’s creditors. One such creditor, Mishmeret-Trusts Company Ltd. (“Mishmeret”), and Mishmeret’s long-time counsel Ofer Shapira (“Shapira”), retained the law firm TKD to represent them in at least some of those disputes against Maiman.

In 2015, Spizz Cohen dissolved, and the Trustee joined TKD as a partner. The Trustee subsequently filed an application under Bankruptcy Code section 327(a) to retain TKD as substitute general bankruptcy counsel, disclosing that TKD had previously represented Mishmeret and Shapira but asserting that the firm no longer represented either party. Citing TKD’s representation of Mishmeret and Shapira, Maiman objected to the Trustee’s application and cross-moved to remove the Trustee for “cause” pursuant to Bankruptcy Code section 324(a). Upon further briefing and an evidentiary hearing, the bankruptcy court (1) granted the Trustee’s application to retain TKD, and (2) denied Maiman’s cross-motion to remove the Trustee for cause.

On appeal in the Second Circuit, Maiman argued that the bankruptcy court erroneously granted the Trustee’s application to retain TKD because the firm (1) represented interests adverse to the estate under Bankruptcy Code section 327(a), and (2) had an “actual conflict of interest” under Bankruptcy Code section 327(c). Maiman also contended that the bankruptcy court abused its discretion in denying the motion to remove Spizz as Trustee for cause pursuant to Bankruptcy Code section 324(a).

The Second Circuit first addressed the retention of TKD, finding that Maiman’s factual argument that TKD continued to represent interests adverse to the Ampal estate (namely, Mishmeret and Shapira) was belied by the record. This was because testimony, engagement letters, and billing records indicated that TKD stopped representing Mishmeret and Shapira in 2014. Although Maiman did not dispute that evidence, he contended that TKD still represented Mishmeret and Shapira, even absent an active attorney-client relationship, based on other factors, such as the firm’s ongoing “duties and loyalties” to past clients and possession of privileged materials. The Second Circuit found this argument unpersuasive; even if the Mishmeret and Shapira were properly deemed an “adverse interest,” TKD was not currently representing that adverse interest because the representation had ended. The Second Circuit found that there was no actual conflict of interest under Bankruptcy Code section 327(c) for the same reasons.

The Second Circuit then considered Maiman's cross-motion to remove the trustee, holding that the bankruptcy court did not abuse its discretion in denying Maiman's motion to remove the Trustee for "cause" pursuant to Bankruptcy Code section 324(a). The Second Circuit noted that both the bankruptcy court and district court stated that Maiman did not allege that the Trustee engaged in fraud or caused any actual injury to the estate. Furthermore, the Second Circuit found that Maiman's argument that the Trustee's joining TKD necessitated his removal was unpersuasive in light of its agreement with the bankruptcy court's findings concerning disqualification of TKD under sections 327(a) and 327(c) of the Bankruptcy Code. Accordingly, the Second Circuit affirmed the judgment of the district court.

***Arnold v. First Citizens Nat'l Bank*, 16-4012, 2017 WL 2350235 (2d Cir., May 31, 2017)**

The Second Circuit affirmed the judgment of the district court affirming the bankruptcy court's grant of summary judgment against the bankruptcy trustee (the "Trustee") for debtor Cornerstone Homes, Inc. ("Cornerstone") in its action against First Citizens National Bank, The Community Preservation Corporation, and Elmira Savings Bank (collectively, the "Banks") contesting their alleged lack of standing.

Over the course of its life as an ongoing concern, Cornerstone developed a large portfolio of residential real estate properties in southern New York, mostly in economically depressed communities in the region. In order to build its holdings, Cornerstone initially solicited investment from hundreds of individual investors. These individual investors (the "Individual Lenders") lent Cornerstone funds to purchase and renovate properties in the region in exchange for a promissory note (the "Individual Notes"), secured by a mortgage (an "Individual Mortgage") on one of Cornerstone's residential properties. These loans were relatively small and the rates relatively high, with interest on the Individual Notes generally accruing at ten percent per year.

In 2006 and 2007, Cornerstone sought to refinance these loans at substantially lower interest rates and, to this end, turned to the Banks, each of which entered into separate loan agreements with Cornerstone (the "Bank Loans"). In connection with these agreements, the Banks lent Cornerstone the specified sum, and, in return, Cornerstone separately granted each Bank a mortgage on certain properties in Cornerstone's portfolio (the "Bank Mortgages"). In an apparent effort to avoid New York's mortgage recordation tax, the parties also asked the Individual Lenders to execute a written agreement assigning his or her Individual Mortgage and the associated note to the Bank lending money against the underlying property. The individual security interests putatively transferred by these assignments were consolidated by agreements between each of the Banks and Cornerstone, each of which separately secured a Bank Loan.

After Cornerstone filed for bankruptcy, the Trustee sued the Banks, seeking a declaratory judgment that the Bank Mortgages were unenforceable as a matter of law. It argued that, because the Individual Notes were negotiable notes covered by Article 3 of New York's Uniform Commercial Code (the "UCC"), the Banks had standing under New York law to enforce the Bank Mortgages only if the written assignments executed by the Individual Lenders validly conveyed title to the Individual Notes under Article 3. It further argued that, because Article 3 does not provide for the transfer of title to a negotiable note by written assignment, the

assignments at issue only effected the transfer of the Individual Mortgages, not the Individual Notes. Because the Banks never gained title to the Individual Notes, the Trustee argued that the Banks had no standing to foreclose and thus could not enforce the security interest reflected in the Bank Mortgages against Cornerstone's property.

Turning to the issue of standing, the Second Circuit deemed it critical that, rather than proceeding through purchases of the Individual Notes from the Individual Lenders by the Banks, the Bank Loans were structured as loans from each Bank, respectively, to Cornerstone. The Second Circuit noted that this was directly memorialized in the loan agreements between Cornerstone and the Banks, several of which included a clear promise to pay running from Cornerstone to the applicable Bank, and made no mention of the Individual Notes.

Accordingly, the Second Circuit deemed it incidental that the parties also obtained written assignments of the Individual Mortgages, which they subsequently consolidated by agreement. While these consolidation agreements might have been effective in minimizing the total mortgage recordation tax burden borne by the parties, the Second Circuit held that they do not change the fundamental structure of the Bank Loans, or the fact that Cornerstone granted the Banks a mortgage securing these loans. Because the loans made by the Banks were independently sufficient to support the security interest at issue in this case, the Second Circuit held that the Banks had standing under New York law to foreclose.

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Fifth Circuit

Janvey v. Dillon Gage, Inc. of Dallas, No. 15-11211856 F.3d 377 (5th Cir. May 5, 2017).

This matter involves litigation arising out of the collapse of a massive Ponzi scheme perpetrated by Allen Stanford. Janvey was appointed as the Receiver for the various Stanford entities. One of the entities related to the scheme, Stanford Coins and Bullion ("SCB"), sold coins and metals to the public. Dillon Gage, a wholesaler of metals, bullion, and coins, was SCB's largest supplier. Following the receiver's shut down of SCB on February 17, 2009, Janvey sued Dillon Gage, alleging that six transfers SCB made to Dillon Gage between January 23, 2009 and February 13, 2009 were fraudulent transfers under the Texas Uniform Fraudulent Transfer Act ("TUFTA"). After trial, the jury returned a verdict in favor of Dillon Gage, finding that none of the six transfers were fraudulent. Janvey moved for judgment as a matter of law, which the district court denied. Dillon Gage sought, but was denied attorney's fees. Janvey appealed the denial of his motion for judgment as a matter of law, and Dillon Gage cross-appealed the denial of its motion for attorney's fees.

Before SCB's business was halted, Dillon Gage had extended a line of credit to SCB that had grown to \$2.3 million. SCB often made its payments late and had numerous old outstanding invoices due to Dillon Gage. On January 22, 2009, Dillon Gage halted shipments to SCB until it was paid. Between January 23rd and 30th, SCB made three payments to Dillon Gage totaling \$1.26 million. On February 2, 2009, SCB accepted a payment of \$3 million from the Pre-War Art Gallery (the "Gallery") for an order of 101 gold bars. SCB ordered the gold bars from Dillon Gage, and provided Dillon Gage with an upfront \$3 million payment. Dillon Gage applied the \$3 million payment to the oldest invoices first, and began shipping SCB's backlogged orders. SCB made two additional payments to Dillon Gage, but still owed the wholesaler money to complete the payment on the deal with Gallery. On February 17, 2009, SCB's operations were halted. Gallery never received its order of gold bars; it became a creditor in the receivership.

Under TUFTA, a transfer is fraudulent if it is made "with actual intent to hinder, delay, or defraud any creditor of the debtor." Such intent may be proved directly, or circumstantially by reliance on "badges of fraud." Janvey argued that he had proved direct evidence of fraud on the theory that SCB misappropriated a \$3 million payment made by Gallery to pay down old debts to Dillon Gage, and that SCB knew, or must have known, that the "natural consequence of its action" is that Gallery would be hindered, delayed, or defrauded in collection of its debts. Janvey also argued that SCB was presumptively insolvent because it was not generally paying its debts as they came due. Finally, Janvey challenged four of the district court's jury instructions.

The Fifth Circuit held that the jury could have rationally concluded that SCB did not disregard a substantial risk that the Gallery would go unpaid because it heard evidence suggesting that SCB had sufficient salable inventory to complete the Gallery transaction, even without growing its business. The Circuit Court also held that the jury could reasonable infer SCB was paying its debts as they came due: "evidence merely showing a significant debt and occasional late payments does not establish insolvency as a matter of law." Further, the court held that the jury instructions were proper. The jury instructions did not define intent – an approach consistent with other model jury instructions for states adopting UFTA, and they properly communicated that the jury need not consider all eleven enumerated "badges of fraud" to show SCB's fraudulent intent. Additionally, the jury instructions properly stated Texas law – that a debtor has the right to prefer his obligation to one creditor over another – by stating that a debtor's "mere" intention to prefer one creditor does not indicate fraudulent intent. Finally, the Circuit court held that the district court's definition of assets under Section 24.003 of TUFTA, even if in error, was harmless; it held that balance-sheet insolvency could not been determined because no witness gave a complete accounting of SCB's debts and assets. Accordingly, the Fifth Circuit affirmed the jury's finding in favor of Dillon Gage.

TUFTA provides that "the court may award costs and reasonable attorney's fees as are equitable and just." Tex. Bus. & Com. Code § 24.013. In denying Dillon Gage attorney's fees under TUFTA, the district court concluded that "Janvey's claims 'were not frivolous, unreasonable, or without foundation,' that the litigation represented Janvey's 'most likely avenue by where he can fulfill his goal of maximizing recovery to make whole the Stanford Ponzi scheme's defrauded investors,' and that 'an awards of attorney's fees for Dillon Gage would not be equitable and just.'" Dillon Gage asserted that the district court impermissibly placed a higher burden on prevailing defendants (than on prevailing plaintiffs) by focusing on the frivolousness of Janvey's

claim. In support of this argument, Dillon Gage contended that in *Janvey v. Romero*, No. 3:11-CV-0297-N, 2015 WL 11017950 (N.D. Tex., Sept. 22, 2015), the same district court (Gobey, J.) held that it would always be equitable and just to award fees to a receiver who prevailed at trial in view of a receivership's goals and purposes. Dillon Gage argued that the court's award of fees to the prevailing plaintiff/receiver in *Romero*'s demonstrated unequal treatment of prevailing defendants. The Fifth Circuit disagreed, holding in this matter that the district court (Gobey, J.) did not apply the wrong standard in assessing Dillon Gage's fee request.

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Matter of Selenberg, (Selenberg v. Bates), No. 16-30649, 856 F.3d 393 (5th Cir. 2017)

This appeal involved a dispute over whether a promissory note the debtor, attorney Carl Selenberg ("Selenberg"), gave to his former client, Dianne Bates ("Bates"), was dischargeable in Selenberg's bankruptcy. During his representation of Bates, Selenberg failed to file a malpractice suit on Bates's behalf within the statute of limitations. Selenberg told Bates he did not have malpractice insurance and had no money with which to compensate her. He offered, however, to give her a promissory note in the amount of \$275,000 because there was a possibility he would have money to pay her in the future. After Selenberg filed for bankruptcy, Bates brought an adversary proceeding to have the note declared non-dischargeable under 11 U.S.C. § 523(a)(2)(A)-(B). The bankruptcy court held the debt was non-dischargeable because (i) the promissory note constituted an extension of credit from Bates to Selenberg, bringing the note within the purview of the statute and (ii) Selenberg violated Louisiana's rules of professional conduct by failing to advise Bates to consult independent counsel before accepting the note as settlement of her malpractice claim and, therefore, the note was obtained by actual fraud.

On appeal, Selenberg first argued the promissory note was not an extension of credit. The Fifth Circuit disagreed, reasoning the note had the desired effect of extending the time for Selenberg to pay Bates. Further, the evidence showed Selenberg gave Bates the note to induce her not to pursue a malpractice claim against him. Accordingly, Selenberg received an extension of credit when Bates agreed to accept the promissory note.

Second, Selenberg claimed evidence of actual fraud was lacking because: (i) he did not make any false representations; (ii) he did not intend to deceive Bates; and (iii) Bates did not sustain loss as a proximate cause of his actions. Regarding evidence of false representation, the Fifth Circuit explained that Selenberg's failure to advise Bates to seek independent counsel was a material omission that qualified as a false representation. The Court likewise found sufficient evidence of intent to deceive because Selenberg had attempted to convince Bates that accepting the promissory note was her only option for recovery against him. Finally, the Court held Bates

had sustained a loss as a proximate result of Selenberg's actions; specifically, she had lost the opportunity to pursue her malpractice claim against him.

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This summary is for general information purposes only and is not intended to be and should not be taken as Kirkland legal advice.

Ninth Circuit

In re Keller (Keller v. New Penn Financial), Bk. No. 12-22391, BAP No. EC-16-1152-BJuTa, 2017 WL 2312849 (9th Cir. BAP 2017)

In *In re Keller*, the BAP affirmed a bankruptcy court order denying Debtors' motion for contempt and sanctions against Shellpoint Mortgage Servicing ("Shellpoint") for violations of the automatic stay and for disregarding the confirmation order. Debtors confirmed a Chapter 13 plan which provided for the cure of mortgage arrears by March 31, 2015 and continuing mortgage payments to be made by the trustee. In January of 2016, Debtors learned that Shellpoint had continued to report late payments and past due balances to three credit bureaus and had failed to report the existing bankruptcy.

Debtors argued that Shellpoint's negative reporting constituted a per se violation of §362(a)(6) as an act to collect and further argued that Shellpoint violated the confirmation order which required payments to be applied as if the claim were current and no arrearage existed on the date the case was filed.

The BAP held that a violation of §362(a)(6) requires evidence of harassment or coercion. The BAP reasoned that a per se rule would presume that all credit reporting could serve no other purpose but because reporting serves the purpose of sharing information relevant to future credit granting decisions, it is not an act to collect per se.

The BAP also held that the confirmation order was silent about credit reporting and only governed the manner in which the payments were applied to the claim. Therefore, Shellpoint was not in contempt for violating the confirmation order.

In re Tukhi (Olomi v. Tukhi), Bk. No. 8:15-bk-14015-MW, Adv. No. 8:15-ap-01449-MW, BAP No. CC-16-1318-KuFL, 2017 WL 2345708 (9th Cir. BAP 2017)

In *In re Tukhi*, the BAP reversed a bankruptcy court order dismissing a §523(a)(6) adversary proceeding for plaintiff Olomi's failure to comply with a local rule requiring a pretrial stipulation to

be filed prior to the pretrial conference. At the initial status hearing, the bankruptcy court gave the parties notice that failure to comply with the local rules would result in dismissal.

At the pretrial conference, counsel for Olomi stated that he had misread the requirement to file and serve a pretrial stipulation and thought that filing a joint status report would satisfy the rule. After the court dismissed the case, Olomi simultaneously filed a notice of appeal and a motion for reconsideration. The bankruptcy court denied the motion for reconsideration and analyzed the dismissal under Rule 7041 for failure to prosecute.

The BAP noted that it only had jurisdiction to consider the dismissal because Olomi did not appeal the decision on the postjudgment motion. However, the BAP did have jurisdiction to review any enhanced findings or new factual determinations made in support of the original ruling.

The BAP held that dismissal for failure to comply with a local rule requires culpability higher than mere negligence or fault such as willfulness, bad faith, recklessness, gross negligence, or a repeated disregard of court rules. At the time of the dismissal, there was no prior history of delay or noncompliance, and the reason for noncompliance was that Olomi's counsel misread the rule. The BAP also held that the five *Henderson* factors did not support dismissal under Rule 7041 and dismissal was an abuse of discretion.

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In re Sunnyslope Housing Limited Partnership (First Southern National Bank v. Sunnyslope Housing Limited Partnership), Nos. 12-17241, 12-17327, 13-16164, 13-16180, 2017 WL 2294746 (9th Cir. May 26, 2017).

In *First Southern National Bank v. Sunnyslope Housing Limited Partnership*, in an en banc decision reversing the original panel decision, the Ninth Circuit affirmed the district court's judgment, which affirmed the bankruptcy court's affirmance of a Chapter 11 plan of reorganization, as modified on remand from the district court by holding that: (1) the bankruptcy court did not err in valuing the creditor's collateral in the plan of reorganization assuming its continued use as affordable housing; (2) the plan of reorganization was fair and equitable as required by 11 U.S.C. § 1129(b); (3) the bankruptcy court did not abuse its discretion in finding the plan of reorganization feasible; and (4) the bankruptcy court did not err in failing to allow the creditor, on remand, to make a second election to have its claim treated as either fully or partially secured under 11 U.S.C. § 1111(b).

The principal issue in *Sunnyslope* relates to valuation of the collateral. When a chapter 11 debtor opts for a cram down, a creditor's claim is secured "to the extent of the value of such creditor's interest in the estate's interest in the [secured] property" and the value of that claim is "determined in light of the purpose of the valuation and of the proposed disposition or use of

such property.” 11 U.S.C. § 506(a)(1). The Ninth Circuit has already held in *In re Taffi*, 96 F.3d 1190, 1192 (9th Cir. 1996), that when a chapter 11 debtor “intends to retain property subject to a lien, the purpose of a valuation under section 506(a) is **not** to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral.” Consistent with *Taffi*, the Supreme Court in *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 956 (1997), adopted a “replacement-value” standard for section 506(a) cram-down valuations over a foreclosure sale valuation.

Here, the foreclosure valuation far exceeds the replacement value of the collateral, an apartment complex, because foreclosure would vitiate covenants requiring the secured property to be used for low-income housing. Because of this, the creditor tried to distinguish its case from *Rash*. The court, however, was unconvinced. The court stressed that *Rash* did not adopt a rule requiring the bankruptcy court value the collateral at the higher of its foreclosure value or replacement value. In fact, the Court flat out rejected the notion of a foreclosure valuation. The court further highlighted that *Rash* did acknowledge the possibility of the foreclosure valuation exceeding the replacement valuation but still held its position: no foreclosure valuation. That being said, the Ninth Circuit could not “ignore the command of *Rash*.”

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Tenth Circuit

In re Flying Star Cafes, Inc., (NM Enterprises, Inc. v. Harrington et al.) Adv. No. 16-1060, 2017 WL 1839156 (Bankr. D. N.M. May 5, 2017)

The bankruptcy court held that a creditor lacked standing to prosecute a subordination adversary proceeding under Code section 510(b) as those are “general” claims that belong to the bankruptcy estate, as opposed to “personal” claims that belong to individual creditors so they can only be brought by a representative of the estate. Factually, the debtor objected to claims of two creditors, then filed an adversary proceeding to subordinate those claims under § 510(b). The bankruptcy court approved a settlement whereby third parties would pay monies to the defendant-claimants, they would reduce the amount of their claims, and the debtor would dismiss the adversary proceeding. The order approving the settlement was without prejudice to third parties objecting to the defendants’ proofs of claims and seeking to subordinate those claims. Subsequently, NM Enterprises objected to the claims and sought to subordinate them under § 510(b). After the claim objections were withdrawn, the defendant-claimants moved to dismiss the subordination action for lack of standing. The bankruptcy court construed the motion as being made under Rule 12(b)(1), discussed Article III, prudential and statutory standing, and explained that, after Lexmark Intern., Inc. v. Static Control Components, Inc., 134 S. Ct. 1377 (2014), the inquiry was three-fold: (i) whether a plaintiff possessed Article III standing, (ii) was there a statute that conferred or denies standing, and (iii) if there was no such statute, should

prudential standing concepts be used to dismiss an action? The bankruptcy court concluded that subordination claims were “general” such that the individual creditor lacked standing to bring such a claim. While the court rejected the position that the debtor’s confirmed plan unambiguously reserved unto the Reorganized Debtor the exclusive right to bring subordination claims, it agreed that should be the result based on a broad interpretation of the plan language. The court specifically noting the lack of cases construing § 510(b) in the creditor versus creditor context, but recounted the “majority rule...that creditors may only bring § 510(c) actions if their goal is to subordinate another creditor’s claim to their own,” that is, “[i]f the creditor suffered no particularized injury...it has no standing to seek equitable subordination on behalf of creditors generally,” which was the situation before the Court.

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Eleventh Circuit

From April:

***In re Acosta-Conniff (ECMC v. Acosta-Conniff)*, No. 16-12884, 2017 WL 1396164 (11th Cir. Apr. 19, 2017)**

The chapter 7 debtor successfully convinced the bankruptcy court to grant discharge of her \$112,000 in student loan debt under the “undue hardship” exception contained in 11 U.S.C. § 523(a)(8). But on appeal, the district court reversed, finding the debtor failed to establish the second prong of the *Brunner* test: “That additional circumstances exist indicating that [the debtor’s] state of affairs is likely to persist for a significant portion of the repayment period of the student loans.” *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395, 396 (2d Cir. 1987).

In reviewing the district court’s reversal and the bankruptcy court decision, the Eleventh Circuit Court of Appeals made two important observations. First, the appellate court found that the district court failed to clearly state the standard of review it applied. The bankruptcy court’s findings as to each prong of the *Brunner* test are subject to clearly erroneous standard; interpretation of any legal question related to its fact finding is a legal conclusion subject to *de novo* review. Second, the court reasoned that a court’s consideration of the second prong is prospective only and cannot “look backward to assess blame for the student debtor’s financial circumstances.” *Acosta-Conniff*, 2017 WL 1396164, at *3. The court vacated the district court’s reversal and remanded to the district court so it could clearly delineate the standard of review it applied for each prong of the *Brunner* test.

***Helman v. Bank of America*, No. 15-13672, 2017 WL 1350728 (11th Cir. Apr. 12, 2017)**

Following the conclusion of her chapter 7 bankruptcy case, the debtor brought claims under the Fair Debt Collection Practices Act (“FDCPA”) and the Florida Consumer Collection Practices Act (“FCCPA”) based on post-discharge monthly loan statements relating to two secured loans she held with Bank of America (“BOA”). The district court hearing the case ultimately dismissed the debtor’s FDCPA claims because BOA was not a “debt collector,” and the FCCPA claims for failure to state a claim.

On review, the Eleventh Circuit affirmed the district court’s finding that, as the originator of the loan, BOA did not qualify as a “debt collector” and therefore was not governed by the FDCPA. The debtor’s FCCPA claims advanced the theory that BOA’s monthly loan statements acted as “implied assertions of a right to collect against her personally” and, because of the bankruptcy discharge, such assertions violated the FCCPA because they attempted to collect a debt the BOA knew was unenforceable. The appeals court applied the “least sophisticated consumer” standard and, after reviewing the language in the discharge order and the disclaimer on BOA’s statements, reasoned that no consumer would consider such statements attempts to collect a debt *in personam*. These disclaimers, coupled with the debtor’s presumed sources of knowledge from the bankruptcy process, should have made clear that BOA still had the ability to foreclose its security interest. Such knowledge did not support the debtor’s claims.

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