Bankruptcy Circuit Update

Featuring cases from October 2015

First Circuit

Best v. Nationstar Mortgage LLC (In re Best),
__ B.R. __, 2015 WL 6643649 (1st Cir. B.A.P., Oct. 30, 2015)

The Bankruptcy Appellate Panel for the Court of Appeals for the First Circuit ("BAP") affirmed the bankruptcy court's dismissal of the Chapter 7 debtor's adversary proceeding against Nationstar Mortgage LLC ("Nationstar") for alleged discharge injunction violations.

Debtor alleged that Nationstar's letters received post-discharge violated 11 U.S.C. Section 524(a). However, the bankruptcy court disagreed, and the BAP affirmed, finding that the letters contained disclaimer language applicable to debtors in bankruptcy, and fell within the 524(j) exception of a secured creditor proceeding in the ordinary course of business regarding the debtor's primary residence. The bankruptcy court construed the letters to assert that Nationstar was simply contacting the Debtor to advise it would foreclose because payments on the underlying promissory note were not made, which was not construed to be a discharge injunction violation.

In the Chapter 7 proceeding, Debtor had also asserted that Nationstar did not hold a valid lien. However, during the pendency of the Debtor's Chapter 13 case before converting to Chapter 7, Debtor had filed an adversary proceeding contesting Nationstar's lien, which suit was dismissed for Debtor's failure to prosecute, and which dismissal was an adjudication on the merits of Nationstar's claim per Fed. R. Civ. P. 41(b).

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Second Circuit

***Ke v. Wang,* 2015 WL 5805954 (October 6, 2015)**

The Second Circuit affirmed the district court's holding that the bankruptcy court did not err in holding that a debt owed by debtor Shao Ke ("Ke") to his former business partner, Jianrong Wang ("Wang"), was not dischargeable in bankruptcy. The bankruptcy court and the district court had held that Ke's debt was non-dischargeable because it was incurred through intentional or extremely reckless conduct constituting fraud or defalcation of Peace Food Inc., a business Ke formerly co-owned with Wang.

The Second Circuit first rejected Ke's argument that the bankruptcy court should have been precluded from deciding the issue of Ke's intent because Wang had failed to raise that issue in a prior litigation in state court. Collateral estoppel applies only if an issue was "actually determined" and necessary to support the judgment in a prior action and if the party opposing preclusion had a "full and fair" opportunity to litigate the identical issue in the prior action. The Second Circuit held that neither consideration supported preclusion here. The issue decided in state court was whether Ke had breached his fiduciary duty when he failed to account for Peace Food Inc.'s corporate revenue during his tenure as fiduciary. Breach of fiduciary duty does not require proof of a particular mental state under New York law, whereas defalcation under 11 U.S.C. § 523(a)(4) requires a showing that the faithless fiduciary committed an intentional wrong. The Second Circuit thus found that collateral estoppel did not apply because the state court had no occasion or necessity to make a finding as to Ke's mental state or intent.

The Second Circuit also rejected Ke's argument that the state appellate court's decision to restore Ke's ownership stake in Peace Food Inc. implied a finding that Ke did not intentionally breach his fiduciary duty. The Second Circuit reasoned that Ke was conflating two separate issues, in that the state appellate court's modification did not preclude finding that Ke also breached his fiduciary duty to that business, as that is a separate and distinct conclusion. The Second Circuit found the remainder of Ke's arguments addressing the bankruptcy court's fact-finding and the sufficiency of the evidence to be without merit.

***Pradella v. Neier (In re Richard H. Friedberg),* 2015 WL 5894107 (October 9, 2015)**)

The Second Circuit affirmed the judgment of the district court holding that the bankruptcy court did not err in approving a settlement of all claims against the estate of debtor Richard Friedberg ("Friedberg"). Plaintiffs Giannina Pradella and Milan Olich (together, the "Plaintiffs") challenged the settlement on jurisdictional grounds and on the grounds of issue preclusion.

The Plaintiffs first argued that the South Carolina court that issued a deficiency judgment against two entities wholly owned by Friedberg had exclusive jurisdiction to determine the Plaintiffs' right to recover against those entities pursuant to the terms of a secured note and mortgage between the parties. The Second Circuit, however, found that this argument was foreclosed due to the Plaintiffs' actions. When the Plaintiffs filed a proof of claim with the bankruptcy court, they invoked the special rules of bankruptcy concerning objections to a claim, estimation of a claim for allowance purposes, and the rights of a claimant to vote on the proposed distribution. Because the Plaintiffs had subjected themselves to the bankruptcy court's equitable jurisdiction in proceedings affecting the claim they filed, the Plaintiffs had therefore subjected themselves to all the consequences that attach to such an appearance, including the eventual extinguishment of their claims by the bankruptcy court.

The Second Circuit also rejected the Plaintiffs' second argument that the deficiency judgment issued by the South Carolina court was entitled to full faith and credit in the bankruptcy court, because the bankruptcy court had properly determined that there were two reasons why the usual application of the issue preclusion doctrine should not have a preclusive effect in the bankruptcy court. The first reason was that the bankruptcy court found that the Plaintiffs had misled the South Carolina court by failing to disclose the restriction in the bankruptcy court's lift stay order on their rights to enforce any deficiency judgment. South Carolina law requires that collateral estoppel not be applied "when unfairness or injustice results

or public policy requires it," which the Second Circuit found applicable here. The second reason was that the record supported the conclusion that the trustee did not have an incentive to fully and fairly litigate the Plaintiffs' entitlement to a deficiency judgment under the terms of the mortgage and note, given the terms of the lift stay order and the bankruptcy court's apparent understanding of the same; as such, the "full and fair adjudication of the issue" requirement of issue preclusion was not satisfied.

Schneller v. Journal Registry Company (In re Journal Registry Company),
2015 WL 5999068 (October 15, 2015)

The Second Circuit affirmed the judgment of the district court affirming four orders of two bankruptcy courts. Deferring in large part to the reasoning employed by the lower courts, the Second Circuit found that the district court had properly denied motions filed by James Schneller ("Schneller") to reopen, to reconsider, and for sanctions. The Second Circuit also affirmed the district court's order expunging Schneller's claim. Finally, with respect to Schneller's challenge of the district court's order denying him leave to appeal in forma pauperis, the Second Circuit dismissed the challenge as moot.

Cherry Valley Associates v. Fiorano Tile Imports (In re Fiorano Tile Imports, Inc.),
2015 WL 6123580 (October 19, 2015)

The Second Circuit affirmed the judgment of the district court confirming the seventh amended plan of reorganization of debtor Fiorano Tile Imports, Inc. ("Fiorano"). The district court had found that the plan of reorganization was substantially consummated under 11 U.S.C. § 1101(2) of the Bankruptcy Code, and challenger Cherry Valley Associates, LLC ("Cherry Valley") had not rebutted the presumption of equitable mootness.

On appeal, Cherry Valley raised several issues it had not presented in the lower courts. In the district court, Cherry Valley argued only that the case was not equitably moot because the reorganization plan had not been substantially consummated. On appeal, Cherry Valley did not pursue that argument, and instead primarily argued that equitable mootness should not have applied because of Fiorano's lack of good faith or unclean hands.

Generally, an appellate court will not consider an issue raised for the first time on appeal. However, appellate courts do have discretion to consider arguments waived in a lower court and will exercise that discretion where required to avoid manifest injustice. Nevertheless, in circumstances where parties offer no reason for their failure to raise a new appellate argument in the lower court, the circumstances do not normally militate in favor of exercising discretion to address any new theory.

Here, the Second Circuit found that Cherry Hill forfeited its new arguments because it did not raise them in the lower court. The Second Circuit was also not persuaded by Cherry Hill's arguments that it must consider its new arguments to prevent manifest injustice. Cherry Hill argued that it could not have raised its new arguments in the lower court because *In re Chateaugay Corp.*, 10 F.3d 944 (2d Cir. 1993), made those arguments "unavailable, as a matter of law, in the district court." However, the Second Circuit noted that to the extent that the arguments would have failed in the district court because Chateaugay controlled the case, the same precedent would be equally binding on a panel of the Second Circuit. As such, the Second Circuit reasoned that Cherry Hill should have instead argued that Chateaugay should be

distinguished, or that equitable mootness should not apply for the reasons it pressed on appeal, when before the district court. Doing so would have preserved any argument that Chateaugay should be overruled for appeal.

The only theory that Cherry Valley raised on appeal that it also raised in the district court was its argument that the court was required to consider the propriety of confirming the reorganization plan before deciding whether the case was equitably moot. The Second Circuit stated that its precedent makes clear that the doctrine of equitable mootness permits a court to decide whether an action should be dismissed before reaching the underlying merits of the appeal. The Second Circuit therefore held that the district court did not err by following binding Second Circuit precedent and holding that Cherry Valley's claims were equitably moot without first considering the propriety of the plan of reorganization.

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Sixth Circuit

In re Kizer,
2015 WL 6437435 (Bankr. E.D. Mich. Oct. 2, 2015)

Applying *Clark v. Rameker*, -- U.S. ---, 134 S.Ct. 2242, 189 L.Ed.2d 157 (2014), the Bankruptcy Court for the Eastern District of Michigan sustained objections to claims of exemption by a debtor in his interest in accounts received as a result of the separation of his ex-wife's retirement accounts in a pre-petition divorce. Although the accounts at issue were the type of retirement accounts typically entitled to protection under the federal retirement funds statute, the debtor's interest only arose as a result of the separation of the ex-wife's accounts in the divorce. Upon the filing of the bankruptcy, the debtor specifically claimed exemptions under 11 U.S.C. § 522(d)(12). However, applying the Clark factors (i.e., (i) can the debtor invest additional money; (ii) is the debtor required to withdraw at or by any particular time sooner than retirement; and (iii) can the debtor withdraw at any time without penalty), the Court sustained the objections. The second factor was not present; however, the first two were.

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Seventh Circuit

William A. Brandt, Jr. v. Horseshoe Hammond, LLC,
2015 WL 5936354 (7th Cir. Oct. 13, 2015)

On October 13, 2015, the Seventh Circuit affirmed the decision of the bankruptcy court, holding that summary judgment in favor of a casino was proper where the casino was able to establish the good faith defense under 11 U.S.C. § 550(b)(1).

Specifically, the US Trustee alleged that the debtor company had made fraudulent transfers to its original owner ("Player"), and that Player then used the funds at Horseshoe Casino. The Trustee sought to avoid the transfers to the casino, totaling $8,248,000, under 11 U.S.C. § 544, 548 and 550. The casino moved for summary judgment under § 550(b)(1)'s good faith defense, arguing it had acted without knowledge of the fraud involved in taking the money out of the company. The "good faith" defense applies "if the transferee: (1) is an immediate or mediate transferee under § 550(a)(2); (2) took the transfers for value; (3) took the transfers 'in good faith;' and (4) took the transfers 'without knowledge of the voidability of the transfer avoided.'" Only the last two elements were at issue.

First, the Seventh Circuit held that the words "the transfer avoided" in the fourth prong refer only to the first part of the two step transfer (i.e. to the transfer from debtor to Player, and not to the transfer from Player to the casino). (Slip. Op. 8-9). Next, the Court held the casino took the funds "without knowledge" because (a) the casino was not aware of any impropriety of the first part of the two-step transfer, and (b) there were insufficient "red flags" to impose a duty on the casino to investigate the first-step transfers because the mere fact of money being transferred from a company to one of its owners "does not hint at fraudulent conveyance by a firm on the brink of insolvency." (Slip. Op. 11-12). Also, although § 550 allows for imputed knowledge or inquiry notice, it was "virtually impossible" that the casino would have actually uncovered either the fraud or the debtor's distress through inquiry. (Slip. Op. 12). Finally, the Seventh Circuit held that Horseshoe acted "in good faith" because it did not know of the fraud and had "no way of knowing the transactions from [debtor] to Player were voidable, and thus, was not closing its eyes to the creditors' plight." (Slip. Op. 14).

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<u>Eighth Circuit</u>

***In re Bruess*, 2015 WL 6847734 (8th Cir. BAP Oct. 29, 2015)**

This matter addressed an appeal from the bankruptcy court's order sustaining the trustee's objection to the debtor's claim of an exemption in her homestead property. The debtor sought to exempt her interest in real property valued at $562,760.33 under Minnesota law which allows for a homestead exemption which allowed for a homestead exemption up to $975,000 if the homestead used primarily for agricultural purposes. The trustee objected to the exemption on the basis that the debtor had acquired the property with the 1215-day period preceding the petition date such that the allowable exemption was limited to $155,675 under 11 U.S.C § 552(p).

The issue on appeal was whether the bankruptcy court had erred in finding that the debtor obtained her interest in the real property at the time the deed was recorded rather than at the time it was executed. The transfer was effected by quitclaim deed from the debtor's father, but the deed was executed three years prior to being recorded. Under Minnesota law a transfer of real property occurs when a deed is delivered. The debtor's father executed the deed and then left it with his attorney for a period of three years before directing the attorney to record the deed. The BAP upheld the bankruptcy court ruling, finding the bankruptcy court had not erred in in determining that the debtor's father had not manifested the intent to convey title until the recordation had occurred.

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<u>Ninth Circuit</u>

HSBC Bank USA v. Blendheim (In re Blendheim),
2015 WL 5730015 (9th Cir. Oct. 1, 2015)

The primary issue before the Ninth Circuit was whether so-called "Chapter 20" debtors could strip off a valueless lien on their residence. More specifically, the issue was whether, given that the Blendheims were statutorily ineligible for a discharge in their chapter 13 cases that ineligibility precluded them from stripping off a lien on their primary residence where the mortgage holder's claim had been disallowed. After noting a deep split of authority within the Ninth Circuit, and across the country, the Ninth Circuit joined the only other circuit courts of appeal to address the issue, *In re Scantling*, 754 F.3d 331 (11th Cir. 2014), and *In re Davis*, 716 F.3d 331 (4th Cir. 2013) (decided while the Scantling case was pending before the Eleventh Circuit), as well as Bankruptcy Appellate Panel decisions from the Sixth, Eighth and Ninth

Circuits, *In re Cain*, 513 B.R. 316 (6th Cir. BAP 2014); *In re Fisette*, 455 B.R. 177 (8th Cir. BAP 2011); *In re Boukatch*, 533 B.R. 292 (9th Cir. BAP 2015), the Ninth Circuit held that the Blendheims' ineligibility for a Chapter 13 discharge did not preclude them—subject to completing payments provided for in their Chapter 13 plan—from stripping off HSBC Bank USA's (HSBC) first mortgage lien given prior disallowance of its claim. Factually, the Blendheims filed their Chapter 13 cases the day after they received discharges in their Chapter 7 cases which rendered them statutorily ineligible for a Chapter 13 discharge. 11 U.S.C. § 1328(f). HSBC did not respond to the debtors' objection to their claim which was consequently disallowed by default; the bankruptcy court denied HSBC's motion for reconsideration as it was on actual notice of the objection and elected not to respond even after warnings from the bankruptcy court. The Blendehims filed an adversary proceeding seeking, among other things, to void HSBC's senior lien on their residence under Code section 506(d), and after denial of HSBC's motion for reconsideration, moved for summary judgment on their lien avoidance claim. The bankruptcy court ruled that, upon completion of payments contemplated by the debtors' plan, HSBC's lien would be void. Subsequently, that plan was confirmed over HSBC's objection based on the Blendheims' ineligibility for a Chapter 13 discharge. The District Court explained that it "should not impose a discharge requirement on the debtor's ability to strip a lien when none is required by statute." The Ninth Circuit affirmed, agreeing that due to disallowance of HSBC's claim Code section 506(d) compelled the conclusion that its first priority lien was void. With Blendheim, the only circuit courts of appeal to have addressed the issue have now held that ineligibility for Chapter 13 discharge does not preclude a Chapter 13 debtor from stripping off a valueless lien. Of note, in Blendheim the lien at issue had no value because the underlying claim had been disallowed, as compared to Scantling and Davis where the liens had no value because the values of the debtors' homes were less than the amount of the lenders' claims and lien stripping was based primarily on operation of Code section 506(a) and 1322(b), as opposed to Code section 506(d) at issue in Blendheim.

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America's Servicing Co. v. Schwartz-Tallard (In re Schwartz-Tallard), ___ F.3d ___, 2015 WL 5946342 (9th Cir. Oct. 14, 2015)

In *American's Serving Company v. Schwartz-Tallard*, the Ninth Circuit affirming the Bankruptcy Appellate Panel's decision held that 11 U.S.C. § 362(k) authorizes an award of attorney's fees reasonably incurred in a debtor's prosecution of a suit for damages to provide redress for a violation of the automatic stay. When a debtor files for bankruptcy, an automatic stay is imposed on virtually all actions against the debtor to collect pre-petition debts under section 365(k) of the Code. To deter and provide redress, the Code permits injured debtors to sue for "actual damages, including costs and attorneys' fees." 11 U.S.C. § 362(k). Other circuits

interpreted this section to include attorneys' fees incurred in prosecuting damages but the Ninth Circuit in *Sternberg v. Johnston* limited fees to end violations of the Stay. With this decision, the Ninth Circuit, sitting en banc, overruled *Sternberg v. Johnston*.

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10th Circuit

Weinman v. Walker, (In re Adam Aircraft Industries, Inc.)
2015 WL 5973397 (10th Circuit BAP, October 15, 2015)

This case involved claims by Adam Aircraft Industries ("AAI") against its former president and board member Joseph Walker. AAI's Board of Directors decided to replace Walker as both president and board member but were concerned that his termination might threaten its ability to obtain debt financing. In lieu of termination, the board negotiated Walker's voluntary resignation on the following terms: (1) Walker would remain on AAI's payroll as a consultant for a set period of time with a promise not to compete with AAI; (2) Walker would retain his health benefits; (3) AAI would return a $100,000 deposit Walker had put down for the securement of an airplane; and (4) AAI would refund $100,000 that Walker had invested in AAI's stock.

AAI thereafter filed for Chapter 7 bankruptcy. It sought to avoid and recover transfers to Walker under the terms of the resignation agreement, arguing that such transfers were avoidable and recoverable under, inter alia, 11 U.S.C. § 548. The bankruptcy court held: (1) that Walker ceased being a "statutory insider" under § 548(a)(1)(B)(ii)(IV) after his resignation; (2) that Walker did not fit the definition of a non-statutory insider; and (3) that Walker gave reasonably equivalent value for the transfers he received from AAI.

The Tenth Circuit affirmed the bankruptcy court's finding that Walker's resignation ended his status as a statutory insider, citing the follow as evidence of a "clean break" with AAI: (1) Walker's successor immediately assumed the position; (2) Walker never returned to AAI's premises after his resignation; (3) the minutes of the board meeting at which Walker's resignation was accepted noted that the resignation had already taken effect. For substantially the same reasons, the Tenth Circuit affirmed the bankruptcy court's determination that Walker did not qualify as a non-statutory insider, noting: "Absent more evidence, an employee negotiating the terms of his termination soon after learning that the company intended to fire him cannot be considered to possess either the type of control of − or relationship to − a company necessary to constitute a non-statutory insider." Op. at 11-12.

The Tenth Circuit further affirmed the bankruptcy court's conclusion that Walker gave reasonably equivalent value for the transfers he received from AAI. Absent evidence to the contrary, the court reasoned that AAI benefitted from these transfers because it received noncompetition, goodwill, and waiver of claims.

Patricia A. Gepner v. Irma Eileen Kidd (In re Irma Eileen Kidd)
2015 WL 6437480 (10th Cir. BAP, October 23, 2015)

This appeal involved a challenge to the Bankruptcy Court's judgment in favor of Debtor on appellant/plaintiff's adversary complaint wherein plaintiff sought denial of the debtor's discharge based on allegations of fraud pursuant to 11 U.S.C. § § 727 (a)(2) and (a)(4). Plaintiff loaned money to debtor's husband which Debtor agreed in writing to pay the debt if her husband died before the debt was paid in full. Debtor's husband died prior to paying off the debt. Following his death, Debtor received various life insurance proceeds. Debtor also inherited certain stock which she later sold for $4,400.00. Debtor engaged in various transfers of these funds to family members, which transfers occurred more than one year before Debtor filed bankruptcy. Debtor, as well as her family members who received the transferred funds, each testified that the monies were at all times considered "family money" which the parties had all intended to be split equally between them.

Plaintiff objected to Debtors' discharge arguing that Debtor's transfer of the ownership of the funds was a fraudulent attempt by Debtor to keep plaintiff from collecting the debt owed to her.

The Bankruptcy Court, after a trial on the merits wherein the parties submitted evidence and testimony, determined that plaintiff was unable to establish actual subjective intent to defraud plaintiff and found in favor of Debtor on Plaintiff's complaint seeking denial of the Debtor's discharge.

On appeal, the Bankruptcy Appellate Panel ("BAP"), upheld the Bankruptcy Court's fact-intensive decision applying the "not clearly erroneous standard" stating that "[a]lthough the bankruptcy court could have reached a different result based on the evidence, having reviewed the entire record, we do not have a firm and definite conviction that the bankruptcy court made a clear error of judgment or went beyond the boundaries of permissible choice." Absent actual fraudulent intent, Plaintiff's claims under 11 U.S.C. § § 727 (a)(2) and (a)(4) fail. Judgment in favor of Debtor affirmed.

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11th Circuit

In re Horne, — Fed. App'x —, 2015 WL 6500754 (11th Cir. Oct. 28, 2015)

Background: Appellant was the plaintiff in a state court lawsuit initiated against the defendants after the filed a chapter 7 bankruptcy petition. In bankruptcy court, the

defendants/debtors filed motions seeking damages for violations of the automatic stay and discharge injunction. The bankruptcy court granted the debtor's motion for sanctions and awarded damages, including roughly $75,000 in attorney's fees.

After losing on her appeal of the sanctions judgment, the plaintiff moved to recuse the bankruptcy judge and vacate the sanctions judgment after she discovered that the debtor's attorney's paralegal, who was a witness in the case, was the sister of the judge's courtroom deputy. Both lower courts denied the motion for recusal, but the district court did not award attorney fees for the second appeal because it assumed the plaintiff was only appealing the discharge injunction sanctions, not the automatic stay sanctions.

Analysis: The court ruled that mere relation of a member of chambers to a witness in a case is not cause for recusal. Moreover, the debtor was entitled to attorney fees incurred on appeal of the plaintiff's recusal motion. Although attorney fee sanctions for violating the discharge injunction violation are discretionary under § 105, attorney fees for a stay violation are mandatory. See 11 U.S.C. § 362(k). Because the record did not support the district court's conclusion that the appellant was only appealing the discharge injunction portion of sanctions, fees the court remanded the case for determination of attorney fees incurred in the recusal appeal.

In re McFarland, — Fed. App'x —, 2015 WL 6081121 (11th Cir. Oct. 12, 2015)

Background: Prior to filing a chapter 7 bankruptcy petition, the debtor conveyed a one-half interest in real property to himself and his wife as tenants by the entireties. The couple purchased the property in 1968 in the debtor's own name. The debtor argued the wife had an equitable interest in the property, by resulting trust or constructive trust, and that his pre-petition transfer only transferred bare legal title. Thus, under 11 U.S.C. § 541(a)(1), the interest transferred by the debtor was not estate property and the transfer of title to the one-half interest was not a transfer of debtor property subject to avoidance as a fraudulent transfer.

Analysis: The court held that the debtor did not hold one-half interest in purchase money a resulting trust for his wife because they did not have an agreement that she would contribute half of the purchase price as required by Georgia statute. The debtor and his wife's mere intent to own the property jointly does not equate to an intent to create a purchase money resulting trust. Therefore, the pre-petition transfer of title constituted a "transfer of property of the debtor."

Moreover, the court affirmed the lower courts' findings that that the transfer was constructively fraudulent, declining to consider the bankruptcy court's actual fraud findings. No "value" was given by the wife in return for the transfer; "love and affection" is inadequate. One interesting takeaway is that the court found it did not need to place a precise value on the property; it was clear the property was worth something, and the debtor received nothing.

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