Bankruptcy Circuit Update
Featuring cases from October 2018

We will be convening our next section-wide conference call on **Friday, November 30th, at 3:30 E.S.T./12:30 P.S.T.** to present and discuss notable cases from the past few months of the summaries. We are seeking volunteers to summarize significant or interesting cases. Please send an email to csullivan@diamondmccarthy.com if you are interested in presenting. The call-in information is: **dial in 866-690-2070 – code 787-594-2077**.
We hope you will join us for this call.

Fourth Circuit

In re Javed,
No. 17-20067, 2018 WL 4955839, (Mem) ((Bankr. D. Md. 2018) (slip copy)

A Maryland bankruptcy court held that a general unsecured creditor is entitled to a limited administrative expense claim for actions it took before the Chapter 7 trustee was actively engaged in the case. General unsecured creditor CPD filed a motion requesting an administrative expense claim for making a substantial contribution to the debtor's estate, alleging it identified assets and assisted the trustee's duties for the benefit of all creditors. In determining whether CPD was entitled to an administrative expense claim of $7,987.50 under section 503(b) of the Code, Judge Harner discussed the purpose of this section, which only expressly mentions chapter 9 and chapter 11 cases. Unlike in a chapter 9 or chapter 11 situation, in which the debtor generally has control of its property as a municipality or debtor in possession, creditors that take independent actions in a chapter 7 case "could conflict with, duplicate, or undermine the trustee's efforts on behalf of the estate and all creditors." Thus, Judge Harner held, a chapter 7 individual creditor must rebut the presumption against awarding substantial contribution claims to individual creditors by demonstrating "extraordinary circumstances" that merit the award of an administrative expense claim.

Here, CPD's actions prior to the debtor's 341 meeting of creditors and the chapter 7 trustee's active engagement led to the Debtor disclosing assets he had allegedly transferred prepetition to family or not otherwise disclosed in the filings. CPD filed an adversary proceeding against the debtor seeking to hold the claims underlying its judgment against the debtor non-dischargeable, followed by a Motion for Rule 2004 Examination of the Debtor, resulting in the debtor amending his schedules of assets and liabilities and his Statement of Financial Affairs. Judge Harner concluded that CPD's knowledge of the debtor's prepetition financial affairs gained in state court litigation, combined with its early actions in the bankruptcy case, helped provide information that resulted in the trustee recovering at least four vehicles, which were promptly sold for the benefit of the estate.

On the other hand, Judge Harner did not view CPD's actions after the active engagement of the trustee as a substantial contribution to the estate. CPD's sharing of a valuation assessment for the debtor's residence and insisting that the real estate agent's list price was too low occurred

after the trustee secured the deed and decided to sell the property. Judge Harner concluded that CPD already had incentive under the Code to help the trustee maximize the property's value in order to facilitate recovery by creditors. A creditor's withholding such information pending an expected reward "could create an incentive structure" that frustrates public policy.

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Fifth Circuit

In re Wolf,
739 Fed. App'x 290 (5th Cir. 2018).

A pro se debtor appealed two orders issued by the bankruptcy court. The first order granted attorney's fees to Chapter 7 Trustee's counsel based on the framework provided by *CRG Partners Grp. v. Neary (In re Pilgrim's Pride Corp.)*, 690 F.3d 650 (5th Cir. 2012). The second order approved the Trustee's employment of an accountant. The district court affirmed both orders.

In reviewing the order granting attorney's fees to Chapter 7 Trustee's counsel ("Counsel"), the Fifth Circuit reviewed the record to determine if the bankruptcy court abused its discretion. In their application for compensation, Counsel informed the court that their rates were similar to those customarily charged by comparably skilled practitioners in El Paso. Moreover, one of the attorneys worked at a reduced rate. Using the lodestar method, Counsel calculated the time spent performing legal services and added it to their out-of-pocket expenses. Counsel did not adjust their fee upwards. The Fifth Circuit found that the bankruptcy court did not abuse its discretion in awarding Counsel's application for compensation.

Regarding the second order that approved Trustee's employment of an accountant, the Fifth Circuit did not find any legal basis to find that appointing an accountant was improper. There was no evidence that the accountant held an interest adverse to the estate, and the accountant assisted Trustee with the necessary function of filing tax returns on behalf of the estate.

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HSBC Bank USA, NA as Trustee for Merrill Lynch Mortgage Loan Asset-Backed Certificates Series 2005-WMCI v. Crum,
907 F.3d 199, 2018 WL 5020609 (5th Cir. Oct. 17, 2018)

In this case, the Fifth Circuit considered the length of time the statute of limitations applicable to HSBC Bank's ("HSBC") foreclosure claim against Kenneth Crum ("Crum") was tolled during his bankruptcy case. After receiving a notice of default and acceleration on his home equity loan from HSBC in June 2009, Crum filed for Chapter 7 bankruptcy and received a discharge from the Bankruptcy Court in October 2010. In September 2014, HSBC filed a foreclosure suit against Crum, and the district court granted summary judgment in its favor.

Crum appealed, arguing that (i) HSBC lacked standing because it was not the holder of Crum's note at the time the case was filed and (ii) HSBC's suit was time barred. The Fifth Circuit summarily dismissed the former argument, finding HSBC presented undisputed evidence that it held the note at all times after 2009.

With respect to statute of limitations, the parties agreed that Crum's bankruptcy tolled the statute of limitations on HSBC's foreclosure claim but disagreed regarding the length of the toll. Relying on statutory rules related to computation of time, Crum argued that the tolling period should be limited to the exact amount of time the automatic stay was in place, excluding the first day it was instituted, rendering HSBC's claim untimely. HSBC countered that tolling was appropriate for the entire time that Crum's bankruptcy petition was pending.

The Court explained that because 11 U.S.C. § 108, which outlines the effect of a bankruptcy stay on statutes of limitations, did not create a separate tolling provision, it was necessary to determine whether another federal or state tolling provision incorporated by § 108 suspended the limitations period during the stay. Although the Texas Supreme Court had not yet ruled on the issue, the parties accepted a line of Texas cases that hold the state's common law tolling rule is an applicable non-bankruptcy tolling provision incorporated by § 108(c). Pointing to the plain language of the common law rule, which allows tolling during the time in which a person is prevented from exercising his legal remedy by the pendency of legal proceedings, the Fifth Circuit found the statute of limitations was tolled every day the automatic stay was in place—including both the day it was implemented and the day it was lifted—because HSBC was prevented from exercising its legal remedies against Crum on both of those days. More specifically, the Court rejected Crum's reliance on procedural rules regarding computation of time because those rules only apply where, unlike here, the applicable law does not itself provide a computation method.

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Matter of Provider Meds, L.L.C.,
____ F.3d ___, 2018 WL 5317445 (5th Cir. Oct. 29, 2018)

In this case, the Fifth Circuit held that a patent license agreement that was not disclosed in the debtors' schedules was an executory contract that was deemed rejected by operation of law under Section 365(d)(1) of the Bankruptcy Code in a Chapter 7 bankruptcy proceeding.

The OnSite entities placed pharmaceutical dispensing machines in long-term care facilities and used proprietary OnSite software to dispense pharmaceuticals to nurses in those facilities. In 2012 and 2013, six OnSite parties filed separate Chapter 11 bankruptcy cases. But a few years prior to the OnSite bankruptcy, Tech Pharmacy Services ("TechPharm") had sued several OnSite parties claiming patent infringement; OnSite counterclaimed, challenging the patent. TechPharm and OnSite settled the litigation, and as part of the settlement, TechPharm granted OnSite a "non-exclusive perpetual license" for so long as the patent is enforceable. In exchange, OnSite agreed to pay a one-time licensing fee for each machine placed into operation after the settlement and to provide quarterly reports reflecting all new machines placed into service. Both parties released any and all claims relating to the patents, the litigation, or any alleged infringement, except obligations specifically called for under the settlement agreement.

When the OnSite debtors filed bankruptcy, none of them disclosed the license agreement in their schedules. The cases were then converted to Chapter 7 proceedings. Subsequently, RPD purchased collateral from three of the OnSite estates; each asset purchase agreement failed to mention the license agreement, but provided that to the extent any subject property was an executory contract, it was assumed by the estate and immediately assigned to RPD under Section 365. After the court approved the three sales, the trustees from the other OnSite estates entered into a "global settlement" with RPD and CERx, a competing creditor. Under the global settlement agreement, two of the trustees would transfer their TechPharm licenses to CERx, but RPD would be "entitled to all remaining TechPharm licenses (such as those otherwise acquired from [the other three OnSite entities])."

A year after the global settlement was approved, TechPharm sued several defendants, including two OnSite debtors, alleging they had failed to comply with their obligations under the license agreement. RPD intervened, removed to the bankruptcy court, and argued that the license had been transferred to RPD. The bankruptcy court concluded that RPD did not have rights under the license agreement because the license agreement was an executory contract that was rejected by operation of law prior to any alleged transfer. The district court affirmed.

The Fifth circuit likewise affirmed, holding that because the license agreement was deemed rejected by operation of law prior to the bankruptcy sales, the license was not part of the bankruptcy estate at the time of the relevant sales, and the bankruptcy court's final orders did not effect a transfer of the license from OnSite to RPD. First, the Court determined that the license agreement was an executory contract because each side – TechPharm and OnSite – had ongoing obligations, of which the failure to perform would constitute a material breach excusing the other side's performance. TechPharm was obligated to refrain from suing for patent infringement for machines placed into serve after the agreement's execution; OnSite was required to provide quarterly reports as to new machines and pay a one-time licensing fee for each new machine.

Second, the Court, relying on Ninth Circuit analysis of an earlier version of the Bankruptcy Code, held that the trustee has an affirmative duty to "investigate the financial affairs of the debtor" under Section 365(d)(1). When a trustee fails to schedule an executory contract (like the license agreement) because the trustee is unaware of such contract, the sixty-day provision of Section 365(d)(1) will nonetheless apply in Chapter 7 cases. Thus, "if the trustee does not assumer or rejected an executory contract…of the debtor within 60 days after the order for relief…then such contract is deemed rejected." 11 U.S.C. § 365(d)(1). Even though the license agreement was not disclosed on the debtors' schedules, it was rejected by operation of law under Section 365. Additionally, the Court held that Section 554, which applies to property of the estate that is neither abandoned nor administered, did not apply because a rejected contract ceases to be property of the estate. The Court held, "[a]t a minimum, the statutory presumption of rejection after sixty days is conclusive where there is no suggestion that the debtor intentionally concealed a contract from the estate's trustee."

Finally, the Court determined that RPD could not and did not acquire the license through either the purchase agreements or the global settlement agreement with OnSite, because the license agreement had been removed from the bankruptcy state by operation of law, and it was therefore outside the power of the bankruptcy trustees to attempt to assume and assign the license agreement to RPD.

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Eighth Circuit

In re Heyl,
590 B.R. 898 (B.A.P. 8th Cir. 2018)

The Bankruptcy Appellate Panel ("BAP") affirmed the United States Bankruptcy Court for the Eastern District of Missouri in dismissing the Appellants' adversary complaint.

Steve Conway, through his entity LorCon LLC (collectively, "Appellants"), invested in a real estate development venture, Heyl Partners ("HPSP"), promoted by Debtors Richard Michael Heyl and Jennifer Ann Heyl. In 2007, Heyl Partners ran into financial difficulties, and Heyl presented Conway with the option of transferring the interest from Heyl Partners to Johns Folly ("JFOV, LLC"), which Conway did. On August 31, 2009, Debtors filed a voluntary petition for relief under Chapter 7, Title 11. On August 27, 2010, Appellants commenced an adversary proceeding (the "2010 Adversary Proceeding") against Heyl, alleging false pretenses, false representation and actual fraud related to the JFOV, LLC. Ultimately, the court entered judgment in favor of Heyl. Appellants did not appeal the 2010 Adversary Proceeding.

In October 2012, Conway made a written complaint to the Enforcement Section of the Missouri Securities Division of the Office of Secretary of State (the "Enforcement Section"), raising claims against Heyl and an affiliated company, HPSP, asserting the fraudulent sale of investment interests in HPSP and JFOV. The Enforcement Section investigated and on April 23, 2015, a Consent Order (the "Consent Order") was entered into by Heyl, HPSP, and the Enforcement Section. In the Consent Order, Heyl and HPSP did not admit or deny any of the allegations made. The Consent Order required Heyl and HPSP to pay a fine and costs to the state of Missouri only in the event that they violated the Consent Order within a two-year period after its execution. The Consent Order acknowledged that the Missouri Resident who initiated the complaint had incurred a $79,500.00 investment loss but did not include a monetary judgment or any other form of relief in favor of Conway or any other creditors.

On October 14, 2015, Appellants filed a new adversary complaint with the Bankruptcy Court, which is the adversary proceeding from which this appeal arose (the "2015 Adversary Proceeding"). This time, Appellants sought to except the Debt from Heyl's discharge under 11 U.S.C. § 523(a)(19). A motion to dismiss was briefed and the court ruled in favor of the Debtors.

To resolve the appeal, the BAP examined the requirements of 11 U.S.C. § 523(a)(19). That section provides that a discharge under section 727 does not discharge an individual debtor from any debt if two elements are met: (A) a violation of securities law or fraud in connection with the sale of securities; and (B) a resulting debt that was memorialized in a judgment, settlement or decree. *McKinny v. Allison (In re Allison)*, 2012 WL 3775982, at * 3 (Bankr. E.D.N.C., Aug. 29, 2012). The issue was whether the Bankruptcy Court erred in finding that the debt at issue was not a "result … from" the Consent Order as required by 11 U.S.C. § 523(a)(19)(B).

Appellants argued that their cause of action was premised on the debt that "results … from" the Consent Order, but neither the Bankruptcy Court nor the BAP agreed. The BAP explained that the only debt that resulted from the Consent Order is a debt to the Enforcement Section for a civil penalty and costs. While the Consent Order referenced that a "Missouri Resident" lost $79,500.00, that was not a judgment or a right of collection, it was only a finding of a loss on investments. The BAP acknowledged that the Consent Order may help appellants satisfy the first element, but it does not satisfy the second.

This interpretation and result was similarly reached in the Ninth Circuit in *Tradex Glob. Master Fund Spc Ltd. v. Chui*, 559 B.R. 520, 525-26 (N.D. Cal. 2016), *aff'd sub nom. Tradex Glob. Master Fund SPC LTD v. Chui*, 702 F. App'x 632 (9th Cir. 2017). In *Tradex*, the debtor/investment advisor entered into a consent order with the SEC, but there was no finding of any debt owed to the investor. *Id.* Thus, because the debt allegedly owed to the investor did not "result from" the SEC order, that order did not satisfy Section 523(a)(19). *Id.* Therefore, in order for an investor to file a claim under § 523(a)(19), the debt must actually result from the order the investor is relying on.

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Ninth Circuit

September:

Um v. Spokane Rock 1, LLC,
904 F.3d 815 (9th Cir. 2018)

In *Um v. Spokane Rock*, the 9th Circuit affirmed the district court's affirmance of the bankruptcy court's grant of summary judgment denying discharge to two jointly administered individual debtors under §1141(d)(3).

Creditor Spokane Rock held prepetition judgments against the debtors for fraud and misrepresentation. Spokane rock initially filed an adversary complaint alleging that the judgments were non-dischargeable under §523(a)(3) because the debtors had failed to provide notice of the bankruptcy and had fraudulently concealed Spokane Rock's claims. After the adversary was dismissed as untimely, Spokane Rock filed a second complaint seeking a denial of discharge under §1141(d)(3). The bankruptcy court granted summary judgment in favor of

Spokane Rock.

Debtors conceded that §727(a) would have barred their discharge under chapter 7 but argued that the other requirements of §1141(d)(3) were not met because the plan did not liquidate all of the property of the estate and debtors continued to engage in business after consummation of the plan by finding employment. The Ninth Circuit held that the plan liquidated estate assets notwithstanding the fact that debtors retained membership interests in various LLCs because the assets of those entities were sold to third parties and the membership interests became worthless upon consummation.

Turning to the final requirement of §1141(d)(3), the Circuit determined that it need not decide whether the denial of discharge is triggered only when an individual debtor continues a prepetition business, because the debtors did not engage in *any* business. The Circuit held that both debtors were "employees" and therefore not "engaged in business." The Circuit reasoned that allowing a debtor who could not obtain a discharge under chapter 7 to obtain a discharge under chapter 11 simply by confirming a liquidating plan and accepting employment in a business owned by others would effectively vitiate §727(a).

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October:

Daff v. Good (In re Swintek),
906 F.3d 1100, 2018 WL 5117193 (9th Cir. Oct. 22, 2018)

In *Daff v. Good (In re Swintek)*, the Ninth Circuit Court affirmed the Bankruptcy Appellate Panels decisions to reverse the bankruptcy court's grant of summary judgment in favor of the bankruptcy trustee in an adversary proceeding brought by a judgment creditor who, before the debtor filed for bankruptcy, obtained an Order for Appearance and Examination ("ORAP") lien encumbering the debtor's personal property under California law.

Karen Good ("Good") acquired two money judgments by assignment in 2009 and renewed them in 2010. In June of 2010, a California superior court issued an ORAP, and Good served the debtor Richard Swintek on that day and thus, created a one-year ORAP lien encumbering the debtor's personal property under Section 708.110(d) of California's Civil Code. Two months later, the debtor filed a Chapter 7 bankruptcy petition and Daff became the bankruptcy trustee ("Trustee"). Good then filed proofs of claim in the bankruptcy case for her judgments. In March 2013, Good filed an adversarial proceeding seeking a declaration that her

ORAP lien had priority superior to that of the Trustee. Both parties later moved for summary judgment. The Trustee argued that Good's ORAP lien experienced in June 2011 because she purportedly failed to renew the lien under California's required one-year term. Good countered that, because the debtor filed for bankruptcy *after* the creation of the ORAP lien, it was tolled under Section 108(c) of the Bankruptcy Code.

The bankruptcy court ruled in the Trustee's favor and held that Good's lien had expired in 2011 because the tolling provision was not applicable to ORAP liens. The Bankruptcy Appellate Panel reversed on appeal and found that this issue is controlled by this Court's decision in *Spirtos v. Moreno (In re Spirtos)*, 221 F. 3d 1079 (9th Cir. 2000), where the Court held that Section 108(c) tolls the period for renewing a judgment.

On appeal, the issue before the Ninth Circuit is whether an ORAP lien falls within the scope of Section 108(c). Unpersuaded by the Trustee's arguments below, the Court held that the period in which a creditor may execute on a lien constituted the continuation of the original action that ruled in the judgment and thus, is tolled during the automatic stay.

The Trustee first pointed to Section 362 of the Bankruptcy Code concerning the automatic stay and argued that: (1) the Code distinguishes between the notion of *enforcing* a judgment (Section 362(a)(1)) and *continuing* an action (Section 362(a)(2)); (2) the language in Section 108(c) only references the "*commencing or continuing* a civil action" and is similar, if not identical to Section 362(a)(2); and (3) the present action concerns only the enforcement of judgment. As such, the tolling provision of Section 108(c) does not apply to enforcing a judgment. Unconvinced, the Court observed that the Trustee's argument was premised on the assumption that each subsection under Section 362(a) enumerates a distinct, mutually-exclusive form of creditor activity that falls within the stay's scope. To the Court, overlap is apparent throughout the stay provision's text.

The Trustee next attempted to distinguish the Court's holding in *Spirtos* from the present case by arguing that *Spirtos* addressed the renewal of a judgment itself rather than the renewal of a lien. In response, the Court noted that though a fair point, *Spirtos* relied on another Ninth Circuit decision, *Hunters Runs*, where the court held that Section 108(c) tolled the period during which a creditor could enforce its mechanic's lien. The Court found the ORAP lien analogous to the mechanics lien in *Hunters Run* did, even though the latter is a statutory lien.

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Tenth Circuit

Abruzzo v. Kearney,
No. 18-cv-922 JCH/SCY, 2018 WL 4854638 (D. N.M. Oct. 5, 2018),

In this case the district court found that jurisdiction over three state court actions removed had been automatically referred to the bankruptcy court pursuant to Administrative Order given (i) custom in the district for the bankruptcy court to handle remand motions and questions related to its jurisdiction, and (ii) that the notice of removal affirmatively stated that the removed actions were "related to" a case under title 11 of the Bankruptcy Code. The district court cited to Administrative Order No. 84-0324 which provided that "all cases under Title 11 and all proceedings arising under Title 11 or arising in or related to a case under Title 11 are referred to the bankruptcy judges for the district to the extent permitted by law." The district court cited examples of cases supporting its reference to the "custom" for bankruptcy courts in the district to handle remand motions and questions related to their jurisdiction. Having found that jurisdiction over the removed matters had been referred to the bankruptcy court, the district court directed the Clerk of the Court to transfer those matters to the bankruptcy court. Finally, the district court advised the parties that if either wished the court to exercise jurisdiction over the removed cases they should file a motion to withdraw the reference. [Even where such a motion is filed, and there is a finding that the reference is due to be withdrawn, the usual practice for district courts across the country is to send the matter back to the bankruptcy court to conduct pre-trial proceedings until the matter is ready for trial.]

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