<u>Bankruptcy Circuit Update</u>

Featuring cases from September 2017

Special Announcement
Group Section Conference Call to Discuss Significant Cases

This month our writers Circuit Writers and Section Leaders will be convening our third section-wide conference call on **Friday, October 27th, 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. Volunteers will be summarizing significant or interesting cases. The presenters will be open for questions and lead discussion of key points. We hope you will join us for this call. The call-in information is: **dial in 866-690-2070 – code 787-594-2077**. We had a good first kick-off to this section-wide conference call last month and are looking forward to the second call! If any section–members, whether or not you are a Circuit Writer, would like to volunteer to discuss a significant case or recent bankruptcy development, please e-mail us at <u>csullivan@diamondmccarthy.com</u>.

<u>First Circuit</u>

In re Mary L. Smith (Whitcomb v. Smith), 572 B.R. 1 (1st Cir. BAP Sept. 6, 2017)

In this case, the Bankruptcy Appellate Panel for the First Circuit ("BAP") considered an appeal from a bankruptcy court judgment determining that a state court judgment debt owed by a chapter 7 debtor ("Ms. Smith") to her daughter and son-in-law ("Whitcombs") was exempted from discharge pursuant to §523(a)(6) and §523(a)(2)(A). The appeal arose out of a dispute concerning a piece of real property. A brief summary of the facts follows. Ms. Smith and her late husband acquired the subject property in the 1960s. In 1999, concerns about Mr. Smith's health prompted the Smiths to encourage the Whitcombs to move into the property. The Smiths proposed to build a new-in-law addition for themselves, while the Whitcombs would occupy the main house, pay a portion of the real estate taxes, maintenance, utilities and property expenses, and eventually receive title to the property from the Smiths . Mr. Smith prepared a handwritten two-page agreement memorializing the Smiths' proposal; however, neither the Whitcombs nor the Smiths signed the agreement. The Whitcombs subsequently moved into the property and started making the Smiths' monthly mortgage payments and paying property expenses. Unbeknownst to the Whitcombs, the Smiths increased the debt on the property through repeated re-financings and additional home equity loans. Approximately nine years later, Ms. Smith notified the Whitcombs that they would have to vacate the property, which they did.

In 2009, the Whitcombs sued the Smiths in state court to enforce their rights under the agreement. The state court found that the Smiths had materially breached the agreement by among other things, refusing to transfer title to the property to the Whitcombs and by evicting them. The state court judgment provided in pertinent part that Ms. Smith was required to record a quitclaim deed in favor of the Smiths; alternatively, the Whitcombs could elect an award of money damages against Ms. Smith in the amount of $270,000. Instead of transferring title to the Whitcombs, Ms. Smith filed for chapter 7 bankruptcy and continued to reside in the property and hold title. She listed the Whitcombs $270,000 judgment as a non-priority general unsecured claim in her

schedules. The Whitcombs initiated an adversary proceeding against Ms. Smith asserting a claim under 11 U.S.C. §523(a)(6) for willful and malicious injury. The sole issue at trial was whether Ms. Smith's obligation to the Whitcombs was exempted from discharge because that obligation resulted from willful and malicious injury. The bankruptcy court held that Ms. Smith never intended to abide by the terms of the agreement and her conduct from 1999 onward culminating in the superior court judgment was the result of willful and malicious intent to cause injury. The court then went on to rule sua sponte that Ms. Smith's debt to the Whitcombs was also non-dischargeable under §523(a)(2)(A).

On appeal to the BAP, Ms. Smith argued that the bankruptcy court erred in finding the first two elements of §523(a)(2)(A) satisfied, namely that she made knowingly false representations and that she intended to deceive the Whitcombs. In interpreting the first element of §523(a)(2)(A), the BAP explained that if at the time a debtor made his promise, the debtor did not intent to perform, then he has made a false representation. Thus, if a debtor enters into a contract with the intended not to pay, the contract may provide a basis for an exception to discharge on the grounds of fraud if the other remaining elements are established. Additionally, because the intent to defraud is rarely proven by direct evidence, courts assess this element using a totality of circumstances approach to discern the debtor's subjective intent. The BAP held that because the bankruptcy court's decision was founded on a credibility determination, made with a view toward totality of circumstances, it would accord great deference to the bankruptcy court's findings that Ms. Smith made known false representations and that she intended to deceive the Whitcombs. After considering the evidence at trial, including the testimony of both the Whitcombs and Ms. Smith, and having concluded that the Whitcombs' testimony was credible while Ms. Smith's was not, the bankruptcy court found that despite the agreement to do so, Ms. Smith never intended to transfer title to the Whitcombs, but rather intended to induce the Whitcombs to contribute money and services to the Smiths. Seeing no clear error, the BAP affirmed the bankruptcy court's judgment.

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Second Circuit

***Aniel v. ResCap Liquidating Trust*,**
16-3438, 2017 U.S. App. LEXIS 18154 (2d Cir. September 20, 2017)

The Second Circuit affirmed the judgment of the district court affirming the bankruptcy court's denial of the proofs of claim filed by Erlinda Abibas Aniel ("Aniel") in the bankruptcy of Residential Capital, LLC for lack of standing. Aniel had filed two proofs of claim, alleging wrongful foreclosure of a California property.

The Second Circuit noted that, to have standing, a plaintiff must show (1) an injury in fact that is concrete and particularized, (2) a causal connection between the injury and the defendant's conduct, and (3) that it is likely the injury will be redressed by a favorable decision.

Here, Aniel alleged that her injury arose from the foreclosure of the property, but the Second Circuit found that she did not demonstrate a connection to the property sufficient to establish her standing. Because Aniel was not named on the deed of trust or mortgage note, as evidence of ownership, she cited a later grant deed giving her a one percent interest, an alleged agreement with the property's owner to pay the mortgage, and her own bankruptcy filing. However, the Second Circuit noted that (i) the grant deed postdated the foreclosure proceeding, (ii) Aniel submitted no evidence establishing the alleged agreement with the property owner, (iii) Aniel never formally assumed any obligation for the mortgage loan with the lender's consent, and (iv) Aniel's submissions in her own bankruptcy filing did not establish her standing.

***In re Frumusa,* No. 16-3095, 2017 U.S. App. LEXIS 18330**

The Second Circuit affirmed the order of the district court denying Lawrence Frumusa ("Frumusa") leave to appeal a final decree of the bankruptcy court. In 2010, Frumusa was enjoined Frumusa from filing an appeal in the district court without prior authorization from the district court. Frumusa did not seek the district court's approval prior to filing, and the district court denied leave, finding that the proposed appeal would be frivolous.

The Second Circuit first noted that denial of leave to file, pursuant to a sanction, is analogous to failure to obey a district court order. The Second Circuit had also previously upheld "leave-to-file" sanctions in this context, specifically in the context of an appeal from the bankruptcy court. Here, the Second Circuit held that the district court's 2010 order applied to Frumusa's proposed appeal from the bankruptcy court's final decree. Frumusa argued that the order barred only "new actions," but the Second Circuit noted that the order directs the district court "not to accept any proposed filings from Lawrence Fumusa [sic], unless the Court authorizes such by written order." The Second Circuit also noted that Frumusa's unauthorized appeal was consistent with his prior history of vexatious litigation.

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Sixth Circuit

***McKay v. City of Detroit, Michigan (In re City of Detroit)*,**
--- Fed. Appx. ---, 2017 WL 4310111 (6th Cir. 2017)

After an arbitrator awarded McKay $42,500 in his lawsuit against three Detroit police officers in May 2013, McKay and the City of Detroit (Debtor) signed an agreement providing for

the City's indemnification of its officers and deemed McKay's claim as an unsecured, nonpriority claim. Shortly following McKay's filing proof of claim, but before he could collect his award, Debtor filed for Chapter 9 bankruptcy in July 2013. The City's bankruptcy plan was confirmed, as was the plan's treatment of "Other Unsecured Claims" as "Class 14" claims that would receive around 13 cents on the dollar. The bankruptcy court clarified that § 1983 suits against officers in their individual capacities, unlike suits against officers in their official capacities, were not "claims against the City" and could not be discharged or adjusted by the plan. The court also noted that "nothing in the Plan shall discharge or impair the obligations of the City ... to indemnify" its officers and employees Hence, plaintiffs could pursue their § 1983 claims against individual officers for their full amounts and, after that, the City would indemnify the officers.

McKay sought and received a state court order enforcing the initial award of $42,500. The bankruptcy court, however, agreed with Debtor's argument that McKay had released his § 1983 claims against the officers by signing the settlement agreement and by receiving a Class 14 general unsecured, nonpriority claim in return. The district court affirmed, rejecting McKay's argument that § 1983 claims are by their nature unsecured nonpriority claims whose nature did not change by his agreement with the City.

The Sixth Circuit agreed with the lower courts, pointing out that "courts are not in the business of overriding the terms of contracts when one party has settler's remorse." When McKay bargained for better treatment of his § 1983 claims against officers, trading uncertainty for an immediate, unsecured, nonpriority claim, the terms of his agreement with the City deemed his § 1983 claims "amended, modified and allowed" to convert to a general unsecured, nonpriority claim, whose terms ultimately proved unfavorable for McKay. Even a handwritten notation on the agreement reading "1983" that McKay alleged was written by a City official did not override terms of the settlement agreement. Affirmed.

***In re Lexington Hospitality Group, LLC*,**
2017 WL 4118117, E.D. Kentucky, Slip Copy (6th Cir. September 15, 2017)

Lexington Hospitality Group, LLC (Debtor), incorporated in Kentucky, acquired a hotel in 2015, for which PCG Credit Partners, LLC (Creditor) provided financing. The promissory note was secured by a mortgage and all assets of the hotel and related property. An amended operating agreement, executed with the loan, provided an entity owned and controlled by Creditor a 30% membership of the Debtor's LLC in exchange for financing. The entity was to retain membership, which could not be diluted, until Creditor repaid the loan. The amended operating agreement provided that Debtor could only declare bankruptcy, or dissolve and liquidate its assets, if an Independent Manager, named in the amendment, authorized such action following a 75% vote of the now-four Members. The Independent Manger's role, which consisted of consenting to bankruptcy filing, would terminate upon loan repayment. In a separate article, an amendment contained a condition restricting Debtor's right to file bankruptcy petition "without the advance, written affirmative vote of the Lender and all members of the Company," directly conflicting with the provision requiring a 75% vote of the Members. In 2017, Debtor entered into a forbearance agreement with Creditor after defaulting on the note, which obligated Debtor (not the Members) to execute an addendum to Debtor's operating agreement. The agreement was executed by Creditor and Janee Hotel Corporation, the Debtor's sole Initial Member and Company Manager at

the time of organization (but not its Independent Manager). Two guarantors, including Janee's President as authorized representative, also executed. The agreement required Debtor to transfer an additional 20% equity interest directly to Creditor, rather than Creditor's entity.

In August 2017, Debtor filed for Chapter 11. The petition was signed by Janee's President/Janee Corporation as Debtor's Manager. The Corporate Resolution was also signed by Janee Corporation, as Manager. The resolution directs Janee's President, as Authorized Person, to file for Chapter 11, disclaims any knowledge of the Independent Manager's contact information or whereabouts, and does not indicate whether a member vote was taken. Creditor moved to dismiss, arguing that the bankruptcy restrictions were not followed. Even if the restrictions were excised, Creditor argued that the Amended Operating Agreement and the Kentucky statute do not allow the Company Manager to authorize a bankruptcy filing.

In analyzing whether Janee Hotel Corporation had authority to authorize Chapter 11 filing, the Bankruptcy Court for the Eastern District of Kentucky determined that the company's authority to file bankruptcy is controlled by Kentucky Law, but the validity of the bankruptcy restrictions is a matter of federal law. The bankruptcy restrictions raised uncertainty as to Janee's ability to act alone as Company Manager to authorize filing. On the other hand, the court agreed with Debtor's contention that the bankruptcy restrictions violated public policy and are unenforceable. While recognizing that parties' freedom to contract can be limited by "relevant articles of organization and statutory law," the court underscored "a strong federal public policy in favor of allowing individuals and entities their right to a fresh start in bankruptcy." For this reason, multiple courts have found "prepetition agreements purporting to interfere with a debtors rights under the Bankruptcy Code" unenforceable. Unlike in a corporate governance agreement that retains rights for its owners to decide whether to file bankruptcy, an agreement "forced on members by a creditor solely for its own interest" creates an "an absolute waiver" of Debtor's right to file bankruptcy.

Here, the bankruptcy restrictions were a necessary part of the Creditor's loan, and their purpose was to prohibit Debtor's ability to file bankruptcy without Creditor's consent. Therefore, the restrictions violate federal public policy and are void as a matter of federal law. The remaining terms, still valid despite the invalid provisions, provide the Company Manager broad authority to manage the affairs of the company and do not exclude the ability to file for bankruptcy. Moreover, any limitations on his apparent authority did not limit Janee's ability to file for bankruptcy. Since Janee was the Company Manger at the time the petition was filed, he had authority to approve a bankruptcy filing on behalf of Debtor. Creditor's motion to dismiss denied.

***Sunshine Heifers, LLC v. Citizens First Bank (In re Purdy)*,**
870 F.3d 436 (6th Cir. 2017)

Purdy (Debtor), a dairy farmer, obtained a loan from Citizens First in 2008, using his herd of dairy cattle as collateral. He later refinanced, using an agricultural security agreement and multiple purchase money security interests (all perfected) in all of Debtor's current and future equipment, farm products, and livestock. Debtor then entered into five agreements to lease 435 additional cattle from Sunshine (who also perfected its security interests), in which he was prohibited from terminating the leases, guaranteed net sales proceeds from the cows at the end of the lease term, agreed to replace cows culled from the herd, and allowed Sunshine to inspect the

herd. Instead of culling a portion of the herd every year to replace older cows with younger ones, Debtor sold off the calves of Sunshine's cows and purchased more mature replacements, in contravention of the lease terms, but with Sunshine's knowledge and acquiescence. However, rather than tagging Sunshine's original cows and their replacements with their yellow brand, Debtor tagged the cows covered by Citizens' security interest in white.

When Debtor filed for Chapter 12 bankruptcy in 2012, the Bankruptcy Court for the Western District of Kentucky issued an automatic stay preventing removal of cattle from the farm. Citizens and Sunshine inspected the cattle. Citizens argued that all the cattle were covered by its perfected purchase money security interest, since Debtor owned them. Sunshine argued that it maintained ownership of the cattle, since Debtor leased them, so they were not included in Citizens' security interest. Citizens and Sunshine both filed for relief from the stay preventing livestock removal, and Sunshine moved to extend time to assume or reject unexpired leases. In analyzing whether the leases were true leases or "disguised security agreements," the bankruptcy court determined in 2013 that the lease terms of 50 months exceeded the economic life of a cow, and, with 30% annual culling, an entire herd is likely replaced before 50 months. The court concluded the leases were thus "per se" security agreements meeting the Kentucky statute, thus, Citizens' perfected liens attached to all cows on the date the petition was filed. The court denied Sunshine's motion to lift the stay but granted it to Citizens, which eventually foreclosed on the herd and auctioned the cattle. Sunshine then appealed and requested a portion of the sale proceeds for its share of the sold cattle, but the District court affirmed.

The Sixth Circuit reversed and remanded Sunshine's first appeal in 2014 because Citizens had failed to demonstrate the leases were "security agreements in disguise." The bankruptcy court concluded on remand that Citizens' security interest attached to all the cattle before Sunshine acquired rights in it, hence, all the auction proceeds belonged to Citizens. Sunshine then appealed the final order to the District court, which affirmed the decision in its entirety.

On its second appeal to the Sixth Circuit, Sunshine contended it should receive at least a portion of the auction's proceeds. First, the Sixth Circuit found that the District court's decision to hold an evidentiary hearing on the issue of ownership did not contravene the original mandate because the Sixth Circuit had never decided the issue of ownership. It simply stated in an explanatory section of its opinion that Sunshine may have a reversionary interest and an entitlement to auction proceeds, as claimed in Sunshine's brief. Second, the Sixth Circuit determined the bankruptcy court did not clearly err in finding the entire net auction proceeds belonged to Citizens. Third, absent evidence about the number of cattle branded after Sunshine had registered its brand, Sunshine could not rely solely on a Kentucky statute providing that registered brands appearing in the state report were prima facie evidence of ownership to assert its interest. Affirmed.

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Ninth Circuit

***Mandelbrot v. J.T. Thorpe Settlement Trust, (In re J.T. Thorpe, Inc)*, 870 F.3d 1121 (9th Cir. 2017)**

In *Mandelbrot*, the Ninth Circuit vacated the district court's affirmance of the bankruptcy court's order enforcing a stipulated agreement between attorney Michael Mandelbrot and several asbestos trusts creating under §524(g) ("Trusts").

In 2011, the Trusts determined that Mandelbrot was "unreliable" and had engaged in a pattern of submitting unreliable evidence with asbestos claims. The Trusts filed a proceeding in the bankruptcy court to prevent Mandelbrot from filing future asbestos claims. After two days of trial testimony, Mandelbrot stipulated to be permanently barred from submitting claims in exchange for the Trusts agreeing not to pursue damages and to dismiss their claims for equitable relief. A few days later, Mandelbrot repudiated the settlement and argued that California law rendered the settlement illegal. The bankruptcy court granted the Trusts' motion to enforce the settlement and Mandelbrot appealed.

The district court affirmed the decision and held that neither Cal. Bus. & Pro. Code §16600 nor Cal. R. of Prof. Conduct 1-500 prohibited the settlement.

The Ninth Circuit held that the district court did not address whether federal law governed the case and did not discuss the impact of *Golden v. Cal. Emergency Phys. Med. Grp.*, 782 F.3d 1073 (9th Cir. 2015) which was decided a few months prior and which held that in determining a contract's validity under §16600, courts should focus on whether the challenged provision "restrains anyone from engaging in a lawful profession, trade, or business of any kind." The Circuit also held that neither party adequately argued to the district court that federal law governs. The Circuit remanded the case to the district court to decide whether federal or state law controlled, and whether *Golden v. Cal. Emergency Phys. Med. Grp.*, 782 F.3d 1073 (9th Cir. 2015) had any impact.

Sitting by designation, Judge Korman, reasoned in a comprehensive dissent that the district court did consider *Golden* which was filed as supplemental authority prior to the district court's decision. Judge Korman also reasoned that the question of whether federal or state law applies is purely an issue of law which could be considered by the Circuit whether it was raised below or not, and federal law should apply because of a significant federal interest in enforcing congressionally authorized asbestos trusts and the integrity of the bankruptcy court proceedings. Judge Korman reasoned that California had no interest in refusing to enforce the settlement agreement because the agreement only involved Mandelbrot and not a client, and the agreement was not intended to restrain competition. Judge Korman noted that "there is no reason for the majority to kick the can down the road" especially when doing so will cause the Trusts to expend funds otherwise dedicated to future claimants and those suffering from asbestos exposure.

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Tenth Circuit

**_In re Dollman_, No. 13-13057-j7,
2017 WL 4404242 (Bankr. D. N.M. Sept. 29, 2017)**

The issue in this case was whether the husband and wife chapter 7 debtors in their reopened case could exempt a pre-petition personal injury claim despite not having disclosed the claim on their schedules (or asserted an exemption) prior to the case being closed. The court struck the amended schedules filed by the debtor in their reopened case without prejudice to them moving for an extension of time pursuant to rule 9006(b) to amend Schedule B to include the claim and Schedule C to claim it as exempt. The Trustee claimed that there was no disclosure of the claim at the debtors' 341 meeting in the initial case. The court rejected the agreement by the debtor and trustee to rule on the papers and not schedule an evidentiary hearing. Factually, two years after their initial case was closed, the wife filed a state court lawsuit based on injuries she had suffered from an incident at a Walmart store parking lot. The defendant moved for summary judgment for lack of standing; in response the debtors moved to reopen their bankruptcy case, which motion was granted. Without seeking leave of the bankruptcy court, the debtors filed their amended schedules. The Trustee argued, in part, that the debtors could not amend their claims of exemption after the case was first closed and their claim should be denied on judicial estoppel grounds. As noted by the bankruptcy court, courts are split on the proper interpretation of Rule 1009(a), which limits amendments "before the case is closed," in a reopened case, with courts taking three approaches: (i) amendments to schedules are allowed after a case is reopened; (ii) no amendments to schedules are allowed after a case is closed; and (iii) amendments may be allowed if a debtor establishes that the failure to amend was due to "excusable neglect." The court adopted the last and middle-ground approach, which required an evidentiary hearing and compelled the court to reject the parties' stipulation that it could decide the issue on the parties' papers.

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