BANKRUPTCY LAW SECTION
SINCE 1983

BANKRUPTCYBRIEFS

NEWSLETTER OF THE BANKRUPTCY SECTION OF THE FEDERAL BAR ASSOCIATION

Marc Taubenfeld, Editor *Summer 2019*

CHAIR'S MESSAGE

Welcome to the spring/summer installment of *Bankruptcy Briefs*. My tenure as chair will conclude in September 2019 and I am pleased to tell you that our chair-elect, Chris Sullivan, will become chair. Chris has done an outstanding job on the Board and will continue to do so as chair. Chris has been the driving force behind the Circuit Writer's updates and bi-monthly calls on the updates. Our circuit writer updates have become a useful resource for our members and I look forward to their continued publication.

Over the past six months, our Section has been active. The Board commented on the proposed amendments to the Federal Bankruptcy Rules of Procedure. In summary form, our Section Board commented on changes to Rules 2002(f), 2004(c), and 8012. In doing so, the Board recommended that:

(1) The Rules Committee not adopt a rule requiring notice of an order confirming plan to be served on all parties in the case because the order confirming plan is already served on all parties in the case.

(2) The Bankruptcy Section would caution the Committee's consideration in imposing a standard for proportionality in ESI production for 2004 examinations because applying any standard might result in more litigation regarding application of the standard, as opposed to a court using its discretion to fashion relief based upon the facts and circumstances of a case. The Section noted that parties are free to adopt an ESI protocol for the 2004 examination without the necessity of imposing any standard of proportionality.

(3) Rule 8012 requires a nongovernmental corporate party to a bankruptcy appeal in the district court or bankruptcy appellate panel to file a statement identifying any parent corporation and any publicly held corporation that owns 10% or more of the party's stock (or file a statement that there is no such corporation). The Rules Committee considered and approved for publication amendments to Rule 8012 that track the relevant amendments to FRAP 26.1 for which final approval is being sought. These amendments would add a new subdivision (b) to Rule 8012, addressing disclosure about the debtor. This subdivision would require the disclosure of the names of any debtors in the underlying bankruptcy case that are not revealed by the caption of an appeal and, for any corporate

debtors in the underlying bankruptcy case, the disclosure of the information required of corporations under subdivision (a) of the rule. Other amendments tracking FRAP 26.1 would add a provision to subdivision (a) requiring disclosure by corporations seeking to intervene in a bankruptcy appeal and would make stylistic changes to what would become subdivision (c), regarding supplemental disclosure statements. The Bankruptcy Section supports the proposed amendment to Rule 8012 to conform it to FRAP 26.1.

Additionally, you may be aware that there is pending legislation in Congress to amend 11 U.S.C. § 101 to exclude under the definition of "current monthly income" benefits paid to veterans because of or related to their military service. This proposed amendment — the "Honoring American Veterans in Extreme Need Act" or the "HAVEN Act" — is important to veterans because veterans' benefits are included in "current monthly income", and, as such, a veteran is more likely to fail the Bankruptcy Code's "means test." This pushes veterans into filing for chapter 13 bankruptcy instead of chapter 7 bankruptcy. Recipients of comparable Social Security benefits do not face the same restrictions and may more easily file for chapter 7 bankruptcy. This legislation is significant in that it will allow military veterans to have bankruptcy relief where their only source of income is military disability payments, which when currently included in their mean's test calculations, precludes military veterans from filing chapter 7. Legislation was introduced on March 6, 2019, with 10 Democratic and 10 Republican Senators supporting the legislation. The legislation has bi-partisan support, but it is difficult to predict when the legislation will be passed and presented to the President. This may be the rare situation where Congress passes a measure with bipartisan support and the support of bankruptcy professionals.

Further, I am pleased to tell you that our Board approved a $500 sponsorship to support a diversity initiative in the Eighth Circuit that encourages persons of diversity seeking career paths that may ultimately lead to becoming our next group of judges. The Section is proud to support diversity initiatives and our Board emphasizes diversity on our Board and in the constituency of our CLE panel presentations. The event is titled "Roadways to the Federal Bench" and it is intended to increase diversity within the pipeline for the bankruptcy bench within the Eighth Circuit.

In other news regarding the section's CLE efforts, I am proud to advise you that our Section will be making a presentation at the NCBJ Conference in Washington, D.C. on October 28, 2019. The panel topic is "Mass Torts in Bankruptcy" and the subject matter will include a discussion on how mass tort litigation is adjudicated in bankruptcy. Further, to the extent that bankruptcy court jurisdiction is implicated, the panel will discuss how bankruptcy courts have analyzed jurisdictional issues. The panel will also discuss what claims or causes of action are part of the bankruptcy estate. The panel will also analyze employment issues facing counsel representing mass tort claimants and class action plaintiffs; and settlement considerations in bankruptcy court as well as MDL. Judge Harlin Hale, Bankruptcy Judge for the Northern District of Texas, will moderate the panel. Our panelists include Mark Desgrosseilliers of Chipman Brown Cicero & Cole, LLP, Ericka Johnson of Womble Bond Dickinson, and Ron Meisler of Skadden, Arps, Slate, Meagher & Flom LLP. If you are attending the NCBJ Conference, I encourage you to attend the panel presentation.

Further, we are hopeful that our proposed panel CLE topic — a discussion on the Supreme Court's decision in *Mission Product Holdings, Inc. v. Tempnology, LLC* — will be accepted for presentation at our National Convention in Tampa Bay in September 2019. If it is accepted, and you are attending the Annual Conference, please attend what will be a fascinating discussion of the intersection of bankruptcy and trademark law.

In closing, it has been a privilege to serve as your chair over the last two years, and I want to thank the Board for all its superb work for our Section.

Regards,

Judge Craig A. Gargotta
Chair, Bankruptcy Section
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Constitutional Challenges Arising from Increasing United States Trustee Quarterly Fees Under 28 U.S.C. § 1930(a)(6)(B)

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In chapter 11 bankruptcy cases, the United States Trustee ("UST") collects quarterly fees pursuant to 28 U.S.C. § 1930(a)(6).[1] UST fees are based on the debtor's total disbursements in each quarter and collected until a chapter 11 case is converted or dismissed. The purpose of § 1930 was to create a self-funding UST Office.[2] Courts have opined that assessment and collection of quarterly fees should occur in an equitable manner, and that UST fees should not place undue hardship on chapter 11 debtors.[3] On October 26, 2017, Congress amended the fee schedule in § 1930(a)(6)(B) to provide:

> During each of fiscal years 2018 through 2022, if the balance in the United States Trustee system fund as of September 30 of the most recent full fiscal year is less than $200,000,000, the quarterly fee payable for a quarter in which disbursements equal or exceed $1,000,000 shall be the lesser of 1 percent of such disbursements or $250,000.[4]

This amendment became effective on January 1, 2018 for UST districts, and on October 1, 2018 for Bankruptcy Administrator ("BA") districts.[5] In effect, this amendment impacts reorganized debtors by causing quarterly fees in some instances to increase to $250,000—an amount that potentially harms the feasibility of some chapter 11 plans. As a result, some bankruptcy courts have been reluctant to enforce § 1930(a)(6)(B) in chapter 11 cases where debtors filed before October 26, 2017.

A. *In re Cranberry Growers Cooperative*

Cranberry Growers Cooperative ("Debtor") filed its chapter 11 petition before Congress amended § 1930 to add subsection (a)(6)(B).[6] After § 1930(a)(6)(B)was signed into law, UST fees became due in Debtor's case for certain quarters of 2018.[7] The UST argued that Debtor owed quarterly fees of the lesser of 1% of disbursements or $250,000, because Debtor's disbursements exceeded $1 million.[8] Debtor and the UST, however, disputed whether certain transfers at issue were disbursements under § 1930(a)(6)(B).

The bulk of the disbursements at issue were funds disbursed in a financing agreement between Debtor and CoBank. The financing agreement consisted of a roll-up and revolver.[9] The revolver required Debtor's proceeds be paid directly to CoBank ("Direct Revolver Payments") to reduce the pre-petition credit line, and in turn, CoBank re-advanced Direct Revolver Payments, minus interest and fees,

to Debtor for normal operating expenses ("Direct Revolver Loan").[10] Each Direct Revolver Payment "rolled up" the pre-petition debt into post-petition debt.[11]

The Bankruptcy Code does not define "disbursements." Most courts rely on the plain meaning of disbursements to include any or all transfers of funds from the bankruptcy estate.[12] The court in *Cranberry Growers*, however, declined to follow the broad definition of disbursements.[13] In a fact-intensive analysis, the court held that Direct Revolver Payments did not constitute a disbursement under § 1930(a)(6).[14] Specifically, the court found that funds at issue were not disbursements because the funds were not used solely to settle pre-petition debt.[15] Rather, CoBank received the Direct Revolver Payments, subtracted fees and expenses, and returned the remainder of funds to Debtor for payment of operating expenses.[16] The court's narrowed definition may only apply when disbursements involve a revolving line of credit.[17]

B. *In re Buffets, LLC*

Buffets, LLC and its affiliates ("Reorganized Debtors") filed their chapter 11 petition on March 7, 2016, and the court confirmed a plan on April 27, 2017.[18] After § 1930(a)(6)(B) was applied to Reorganized Debtors' subsequent disbursements, Reorganized Debtors paid 833 percent more in UST fees than originally required at the time of filing the case and plan confirmation.[19] The court declined to adopt the *Cranberry Growers* court's narrow definition of disbursements, finding that "the new UST fees are excessive and certain situations may require a limitation on what constitutes a disbursement," but a narrow interpretation may only apply in cases involving a revolving line of credit, which was not present in Reorganized Debtors' case.[20]

The court found that §1930(a)(6) violated the Uniformity Clause of the Constitution because the increased quarterly fees were not applied at the same time for both the UST and BA districts.[21] The increased quarterly fees became applicable to BA districts in October 2018, which was nine months after the effective date in UST districts.[22] As a result of the non-uniformity, the court held that Reorganized Debtors were not required to pay $250,000 in fees for the first three quarters of 2018 but rather the uniform quarterly fee of $30,000.[23]

The court also determined that § 1930(a)(6) violated the presumption against retroactivity because neither the statute itself nor legislative history indicated that Congress intended retroactive application.[24] Moreover, the amendment's possible retroactive application violated the Due Process Clause of the Constitution because Reorganized Debtors did not receive sufficient notice prior to filing chapter 11 or confirmation of the plan.[25] As a result, § 1930(a)(6)(B) did not apply retroactively to Reorganized Debtors' case for any relevant year.[26] The UST filed an appeal on these issues, which appeal is currently pending in the United States District Court for the Western District of Texas.

C. Pending Class Action Challenges § 1930(a)(6)(B)

Following *Buffets*, seven reorganized debtors ("Plaintiffs") filed a class action lawsuit against the United States in the United States Court of Federal Claims.[27] Plaintiffs' bankruptcy cases were filed in the Western District of Louisiana, which is a UST district.[28] Plaintiffs filed their bankruptcy cases in June 2017 and confirmed a joint plan in February 2018.[29] Pursuant to § 1930(a)(6)(B), Plaintiffs paid the increased UST fees for the first and second quarters of 2018.[30]

Plaintiffs allege that UST districts have been applying § 1930(a)(6)(B) to chapter 11 cases filed before October 26, 2017, but BA districts have limited application of the UST fee increase to cases filed on or after October 1, 2018.[31] Plaintiffs allege that they paid $216,784.69 more in quarterly UST fees than they would have if they had filed in a BA district.[32] Based on these facts, Plaintiffs argue that, under the Uniformity Clause of the Constitution, § 1930(a)(6)(B) is unconstitutional when applied in chapter 11 cases filed before October 1, 2018.[33]

Alternatively, Plaintiffs argue that retroactive application of § 1930(a)(6)(B) for chapter 11 cases filed before October 26, 2017 is unconstitutional under the Due Process Clause.[34] According to Plaintiffs, UST districts have been applying § 1930(a)(6)(B) to chapter 11 cases filed before the statute was passed on October 26, 2017, whereas BA districts started applying § 1930(a)(6)(B) in chapter 11 cases that were filed on or after October 1, 2018. In other words, Plaintiffs contend that there is disparate retroactive application between chapter 11 debtors in BA districts and UST districts.[35] Moreover, Plaintiffs' Complaint suggests that the chapter 11 filing

date should determine whether § 1930(a)(6)(B) applies. Using the filing date could create a bright-line rule that would help courts determine when a chapter 11 debtor has sufficient notice for paying the increased UST fees. Further, having knowledge of when § 1930(a)(6)(B) applies could help chapter 11 debtors account for a fee increase in their plan or restructure debts outside of bankruptcy to avoid the quarterly fees altogether.

This pending class action case could affect all chapter 11 debtors who filed for bankruptcy before Congress passed § 1930(a)(6)(B). BA districts explicitly state on their websites that § 1930(a)(6)(B) does not apply to any chapter 11 debtors who filed before October 1, 2018 and does not have retroactive application to pending cases.[36] If the Court of Federal Claims were to rule in favor of Plaintiffs, the United States could be subject to a judgment award in the amount of increased quarterly fees paid based on a cause of action for illegal exaction under the Tucker Act.[37] ■

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[1] Unless otherwise indicated, all references hereinafter are to to 28 U.S.C. *et seq.*

[2] H.R. REP. NO. 99–764, at 22 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5227, 5234–35.

[3] *In re Cranberry Growers Coop.*, 592 B.R. 325, 331 (Bankr. W.D. Wis. 2018) (citing *In re Smith & Son Septic & Sanitation*, 88 B.R. 375, 384 (Bankr. D. Utah 1988)).

[4] 28 U.S.C. § 1930(a)(6) (2017).

[5] Presently, there are two co-existing programs that provide post-petition supervision of chapter 11 cases: the UST program and the BA program. Alabama and North Carolina operate under the BA program. All other states operate under the UST program.

[6] *Cranberry Growers*, 592 B.R. at 327–28.

[7] *Id.* at 327–28 (noting that the parties stipulated that § 1930(a)(6)(B) applied only to disbursements made on or after January 1, 2018).

[8] *Id.* at 327.

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *See In re Buffets, LLC*, 597 B.R. 588, 593 (Bankr. W.D. Tex. 2019) (defining disbursements to include "all payments made by the [r]eorganized [d]ebtor"); *In re Genesis Health Ventures, Inc.*, 402 F.3d 416, 422 (3d Cir. 2005) (defining disbursements include "payments made on behalf of the debtor"); *In re Danny's Markets, Inc.*, 266 F.3d 523, 526 (6th Cir. 2001) (defining disbursements as "all payments to third parties directly attributable to the existence of the bankruptcy proceeding"); *In re Jamko, Inc.*, 240 F.3d 1312, 1316 (11th Cir. 2001) (holding UST fees apply to all disbursements made pre-confirmation and post-confirmation, including operating expenses); *St. Angelo v. Victoria Farms, Inc.*, 38 F.3d 1525, 1534 (9th Cir. 1994) (defining disbursements as "all payments from the bankruptcy estate").

[13] *Cranberry Growers*, 592 B.R. at 334.

[14] *Id.*

[15] *Id.* at 331.

[16] *Id.*

[17] *See Buffets*, 597 B.R. at 594.

[18] *Id.* at 591.

[19] *Id.*

[20] *Id.* at 594.

[21] *Id.* at 595 (citing *St. Angelo*, 38 F.3d at 1535).

[22] *Id.*at 594.

[23] *Id.* at 595.

[24] *Id.* at 596

[25] *Id.*

[26] *Id.* at 597.

[27] Complaint at 3, *Acadiana Management Group, LLC v. United States*, No. 1:19-cv-10000-UNJ (Fed. Cl. Apr. 3, 2019).

[28] *Id.*

[29] *Id.*

[30] *Id.*

[31] *Id.* at 2.

[32] *Id.*

[33] *Id.* at 3.

[34] *Id.* at 3–4.

[35] *Id.* at 14.

[36] U.S. BANKR. ADM'R NORTHERN DISTRICT OF ALA., https://www.alnba.uscourts.gov/ (last visited May 30, 2019); *Increased Quarterly Fee Calculation*, U.S. Bankr. Adm'r Middle District of Alabama, http://www.almba.uscourts.gov/banews.htm (last visited May 30, 2019); *Chapter 11 Quarterly Fee Schedule*, U.S. BANKR. ADM'R SOUTHERN DISTRICT OF ALABAMA, http://www.alsba.uscourts.gov/drupal/sites/default/files/documents/QuarterlyFeeSchedule_rev%2010_1_18.pdf (last visited May 30, 2019); *Chapter 11 Quarterly Fees Effective October 1, 2018*, U.S. BANKR. ADM'R EASTERN DISTRICT OF N.C. (Sept. 20, 2018), https://www.nceb.uscourts.gov/news/notice-quarterly-fees-increase-cases-filed-or-after-october-1-2018; *Notice of Increased Chapter 11 Quarterly Fees Effective for Cases Filed On or After October 1, 2018*, U.S. BANKR. ADM'R MIDDLE DISTRICT OF N.C., http://www.ncmba.uscourts.gov/news-events.php (last visited May 30, 2019); *Notice of Increased Chapter 11 Quarterly Fees Effective for Cases Filed On or After October 1, 2018*, U.S. BANKR. ADM'R WESTERN DISTRICT OF N.C. (Sept. 24, 2018), https://www.ncwba.uscourts.gov/sites/ncwba/files/Notice%20of%20Increased%20Chapter%2011%20Quarterly%20Fees%20effective%20for%20cases%20filed%20on%20or%20after%20October%201.pdf.

[37] An additional constitutional challenge was filed as this article went to press in the District of Delaware. *See In re Exide Technologies*, Case No. 13-11482 (MFW) (Bankr. D.Del.), Docket Nos. 5188-90 (seeking "declaration that section 1004 of the Bankruptcy Judgeship Act of 2017, Pub. L. No. 115-72, § 1004, 131 Stat. 1224, 1232 (October 26, 2017), which amended 28 U.S.C. § 1930(a)(6) to impose an 833% increase in quarterly United States Trustee ("UST") fees. . . is unconstitutional both facially and as applied to Exide.").

Taggart v. Lorenzen

By: Hon. Craig A. Gargotta
United States Bankruptcy Judge
Western District of Texas

In *Taggart v. Lorenzen*, No. 18-489, 2019 WL 2331303 (S. Ct. June 3, 2019), the Supreme Court ruled by a 9-0 decision that a creditor's subjective good faith in violating the discharge injunction under 11 U.S.C. § 524 was the improper standard to apply to a creditor's conduct. In reversing the Ninth Circuit, the Court held that the standard a court should employ in evaluating whether a creditor's conduct is subject to contempt is the "no fair ground of doubt" standard. In doing so, Justice Stephen Breyer found that a court's enforcement of an injunction rests upon whether "there is no objectively reasonable basis for concluding that the creditor's conduct might be lawful."

Taggart ("Petitioner") owned an interest in a business park with two other owners. The two owners, who are some of the Respondents in the case, claimed that Petitioner violated the business park's operating agreement and filed suit in Oregon state court against Petitioner. Before trial, Petitioner filed chapter 7 bankruptcy. Petitioner received a chapter 7 discharge under § 727 of the Code. Bankruptcy courts utilize a form discharge order that states that a discharge relieves a debtor "from all debts that arose before the date of the order for relief" except those debts under § 523 (that are either nondischargeable by statute or determined to be nondischargeable). A discharge order states that it operates as an injunction from collection of any debt that has been discharged under § 524(a)(2).

The Oregon state court granted judgment against Petitioner *after* Petitioner received his chapter 7 discharge. Further, Respondents sought attorney's fees in state court for litigation fees incurred after Petitioner filed his chapter 7 petition. Notably, under Ninth Circuit precedent, a discharge order would cover post-petition attorney's fees from a pre-petition lawsuit unless the discharged debtor "returned to the fray" (elected to participate in the litigation) after filing for bankruptcy. *In re Ybarra*, 424 F.3d 1018, 1024 (9th Cir. 2005). Respondents argued that Taggart had returned to the fray, and, as such, was liable for post-petition attorney's fees. The state court agreed and awarded Respondents $45,000.00.

Petitioner then sought relief in bankruptcy court, arguing that he had not returned to the fray and that *Ybarra* did not apply. As such, Petitioner argued that his chapter 7 discharge barred the assessment and collection of Respondents' post-petition attorney's fees. The bankruptcy court disagreed and found that Respondents did not violate the discharge order and were not in contempt. On appeal, the district court found that Petitioner had not returned to the fray and remanded the case back to the bankruptcy court. On remand, the bankruptcy court applied

A STRICT LIABILITY STANDARD WOULD EQUATE TO THE SAME TEST COURTS USE IN DETERMINING STAY VIOLATIONS.

a "strict liability" standard to Respondents' conduct and held Respondents in civil contempt, awarding Petitioner $105,000 in attorney's fees and $7,000.00 in damages. Respondents appealed to the Ninth Circuit BAP who vacated the sanctions. The Ninth Circuit affirmed, holding that "a creditor's good faith belief" that the discharge order does not apply to creditor's claim precludes a finding of civil contempt even if the creditor's belief is unreasonable.

The Supreme Court began its analysis by noting that the question presented concerns about the legal standard a bankruptcy court should use to hold a creditor in contempt for attempting to collect a debt that a discharge has "immunized" from collection. The Court discussed that its precedent regarding civil and injunction relief requires it to follow interpretive principles governing the enforcement of injunctions under § 524(a)(2). The Court noted that § 524(a)(2) operates as an injunction and that a bankruptcy court can issue any order or judgment necessary to carry out the injunctive features of § 524(a)(2), including civil contempt under § 105(a) of the Code. Moreover, under the doctrine of equity practice, courts have long imposed civil contempt sanctions to coerce a defendant into compliance with an injunction and to compensate a party for losses associated with a violation of an injunction. That said, the Court found that the bankruptcy statutes do not grant bankruptcy courts unlimited authority to grant civil contempt. Rather, bankruptcy statutes incorporate the traditional standards in equity practice for determining when a party may be held in civil contempt for violating an injunction.

The Court observed that outside the bankruptcy context, civil contempt should not be "resorted to where there is a fair ground of doubt as to wrongfulness of defendant's conduct." The Court noted that this standard should be followed because civil contempt is a severe remedy, and that basic fairness requires that those enjoined receive explicit notice of the conduct that is restrained. Further, this standard is generally an objective one and the absence of willfulness does not relieve a party from civil contempt. The Court held that traditional civil contempt principles apply to the bankruptcy discharge context. The Court noted that the typical discharge order is not detailed, but that Congress has carefully delineated those debts that are exempt from discharge. Therefore, under the fair ground of doubt standard, a court may hold a creditor in contempt for violating a discharge order based upon "an objectively reasonable understanding of the discharge order or the statutes that govern its scope."

In reaching its conclusion, the Court found that the Ninth Circuit's standard of a "creditor's good faith belief" that the discharge order does not apply, even if unreasonable, is unworkable. The Court ruled that a party should not be able to insulate itself from contempt based upon its subjective good faith. Moreover, such a standard relies too heavily on state of mind, and would force a debtor back into litigation over a discharge that is intended to protect a debtor. Further, the Court found the bankruptcy court's "strict liability" standard difficult, because it would cause a creditor to be risk averse and seek a bankruptcy court's determination over discharge matters that ordinarily would be restrained under a facial reading of § 523. A strict liability standard would also increase the amount of litigation with the attendant delay and costs.

Petitioner had additionally argued that a strict liability standard would equate to the same test courts use in determining stay violations. The Court discounted such an analogy, noting that stay and discharge injunctions each rely on different statutory language and serve different purposes. The automatic stay seeks to prevent disruptions to the administration of the bankruptcy estate while a discharge order seeks to bind creditors for a much longer period. Therefore, the Court could not conclude that the same standard of contempt should apply in the stay and discharge violation contexts. ■

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FEDERAL BAR ASSOCIATION / FBA BANKRUPTCY SECTION

UPCOMING **EVENTS**

2019

September 5 - 7
2019 Annual Meeting and Convention
Hilton Tampa Downtown
211 N Tampa Street, Tampa FL 33602

October 28
Mass Torts in Bankruptcy presentation by Panel of FBA Bankruptcy Section Members
NCBJ Conference
Washington, D.C.

November (date to be determined)
Noon: Bankruptcy Section joint presentation with FBA Dallas Chapter at Belo Mansion, Dallas

2020

March 18-21
The Watergate Hotel, Washington, D.C.
Leadership Summit (Midyear Meeting)

March 19
Capitol Hill Day

March 20
Leadership Training

March 21
National Council Meeting and 100th Anniversary Gala Celebration

September 9 - 12
2020 Annual Meeting and Convention
Francis Marion Hotel
387 King St, Charleston, SC 29403

BANKRUPTCY 2004 EXAMINATIONS: Why You Want to Use It

The filing of bankruptcy by an adverse party can result in a major interruption to the "normal" process and procedure of litigation. It can cause delays, additional costs, and procedural nightmares. However, in cases where the filing occurs prior to the initiation of litigation, or where discovery has not opened or concluded, a bankruptcy can provide parties with an otherwise unavailable form of discovery – the Bankruptcy Rule 2004 examination, commonly known as a "**2004 Exam**".

By:
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and

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WHY WOULD YOU WANT TO TAKE A 2004 EXAM?

When a bankruptcy case is filed, creditors may want to obtain discovery from the debtor, the debtor may want to obtain discovery from creditors, and either may want to obtain discovery from third parties. Bankruptcy cases rarely are filed when relationships between adverse parties are neat and tidy. A 2004 Exam permits examination of any party without the requirement of a pending adversary proceeding or contested matter in the bankruptcy case. 2004 Exams are frequently utilized to conduct enough discovery to see whether a reasonable basis exists for the assertion of, and perhaps the filing of, an adversary proceeding or lawsuit. In doing so, litigants can avoid the Rule 11 trap.

THE PROCESS

Rule 2004(a) provides that an examination may be taken "[o]n motion of any party in interest". The term "party in interest" is often used in bankruptcy parlance, but is not specifically defined in the code. Courts have generally construed the term party in interest liberally. Further, Rule 2004 provides that "entities" may be examined. An "entity" includes a person, estate, trust, governmental unit, and United States trustee. A "person" includes individuals, partnerships, and corporations. Corporations include unincorporated and incorporated associations. That is not the limit though, as discovery under Rule 2004 also extends beyond the debtor to persons associated with him, as well as to those persons who may have had business dealings with the debtor. This is a scope much wider than may commonly be accomplished through discovery under the Federal Rules. Although Rule 2004 (a) seems to require a motion and order, in many jurisdictions, local rules or standing orders bypass this requirement. Refer to the local rules of the district and division in which the case is pending to determine the noticing requirements to use. Rule 2004 affords both debtors and creditors the broad rights of examination of a third parties' records. But, third parties subject to examination pursuant to Rule 2004 are only those persons possessing knowledge of the debtor's acts, conduct or financial affairs so far as this relates to the debtor's proceeding in bankruptcy. A non-debtor may be subpoenaed to attend a Rule 2004 examination in the district where he resides, based on a 2004 Exam order issued in a different district than the underlying bankruptcy case is pending.[1] The process can be onerous, but effective. The proper procedure is to obtain the Rule 2004 order in the district where the underlying bankruptcy case is pending, to file a certified copy of the Rule 2004 order in the district where the witness to be examined resides, and obtain issuance of a subpoena from the bankruptcy court in the district where the witness resides compelling the witness to attend a 2004 Exam in the district where the witness resides.

WHO IS ALLOWED TO ATTEND AND ASK QUESTIONS?

Sometimes issues of who may attend a 2004 Exam and who may ask questions arise. Just like meetings of creditors conducted under section 341 of the Bankruptcy Code, 2004 Exams are proceedings generally open to the public. It is critical to the functioning of the bankruptcy process that 2004 Exams of debtors and third parties authorized by the bankruptcy court be open to the public. The public includes not only those parties in interest in the bankruptcy case, but any interested party including press.

SCOPE OF THE 2004 EXAM

The scope of the inquiry under Rule 2004 is very broad and great latitude of inquiry is ordinarily permitted. The policy behind Rule 2004 is for an open-air examination. As a result, 2004 Exams have come to be known as "broad fishing expeditions" into a party's affairs for the purpose of obtaining information relevant to the administration of the bankruptcy estate. A 2004 Exam is different than discovery under the Federal Rules, and, as a result, procedural safeguards of witnesses are at a minimum. For example, courts have held that under Rule 2004, the deponent is not entitled to certain rights afforded automatically under the Federal Rules, such as the right to counsel and the right to object to questions posed. While the scope of the 2004 Exam should not be limited by whether the information sought to be discovered would be admissible at trial, otherwise admissible testimony taken during a 2004 Exam might not be admissible unless a showing can be made that the examination was conducted fairly and in compliance with the Federal Rules.

Despite its characterization as being tantamount to a fishing expedition, a 2004 Exam must be both relevant and reasonable. Matters having no relationship to the debtor's affairs or the administration of the bankruptcy estate are not proper subjects of a 2004 Exam. Further any request that is seen as being overly burdensome or oppressive or used for the purpose of harassment or abuse will not be approved. It is an abuse of Rule 2004 if the primary motive of a 2004 Exam is to use it in litigation for another cause of action, such as to further a case in state court. However, if there are parallel interests in the bankruptcy and the other cause of action, the 2004 Exam is likely to be proper.

Additionally, those seeking to examine witnesses or records pursuant to Rule 2004 examinations are subject to the applicable evidentiary privileges. Bankruptcy Rule 9018 provides that, on motion or its own initiative, with or without notice, the court may make an order which requires to protect the estate or entity in respect of a trade secret or other confidential research, against scandalous or defamatory matters contained in any paper filed in a case under the code, or to protect governmental matters that are made confidential by statute or regulation.

Many times the examinee and other parties will attempt to quash the 2004 Exam. While the 2004 Exam is normally authorized by the bankruptcy court without advance notice, this does not deprive the prospective deponent of the right to object to it after the motion is granted or to file a motion for protective order. Even though the Federal Rules do not apply to a 2004 Exam, the lack of a procedural framework for Rule 2004 proceedings may make borrowing from the applicable Federal Rules appropriate, so that discovery objections under the Federal Rules may be used. For example, the 2004 Exam is subject to a motion to quash a requirement to produce electronically stored information based upon Fed. R. Civ. P. 26's proportionality requirements added by the 2015 amendments to the rule. A mere fishing expedition will be tempered in such cases.

Ethical issues can arise if a subpoena duces tecum is served on a non-party individual who has no ability to produce documents. The form of Subpoena is governed by Fed. R. Civ. P. 45, as codified in Bankruptcy Form 2540. Instructions and limitations of the non-party's duties to produce documents are listed on the back of the subpoena. But what happens if the non-party calls opposing counsel and asks for "help" in understanding the subpoena? Counsel must decide whether to advise a non-client about ways to object to the subpoena or to repeatedly tell the non-party to seek counsel (which they may not be able to afford).

RULE 2004 CEASES TO APPLY ONCE AN ADVERSARY IS FILED

The use of Rule 2004 is not unlimited or available at all times. Once the parties have commenced an adversary proceeding, they may not employ Rule 2004 as a discovery device by which to uncover evidence related to that proceeding. Once an adversary proceeding or particular contested matter is underway, discovery sought in furtherance of that litigation is subject to the Federal Rules rather than Rule 2004.

CONCLUSION

Access to discovery through the Rule 2004 Exam process is a necessary tool when a creditor must make a decision about filing an adversary proceeding or contested matter or the viability of reoganization. Use of the 2004 Exam is a fair process allowing discovery early in the fast moving bankruptcy process. ■

Special thanks to Steve Peirce and Jack Partain of Norton Rose Fulbright, for the use of their article "Bankruptcy Rule 2004 Examinations" in the preparation of this article. Steve is a member of the FBA Bankruptcy Section Council.

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[1]The proper subpoena form is a "Subpoena for Rule 2004 Examination" found in the Federal Rules of Bankruptcy Procedure as form No. 2540 and obtainable on the Bankruptcy website of the district where the case is pending.

Delaware Court Precludes Creditors of Limited Partnership From Pursuing Derivative Claims

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In several cases since the seminal 2011 Delaware Supreme Court decision *CML V LLC v. Bax*, which held that creditors of Delaware LLCs lack standing to pursue derivative claims, the U.S. Bankruptcy Court for the District of Delaware has expanded the jurisprudence regarding the assertion of derivative claims and alternative entities. Most recently, in *Gavin/Solmonese LLC v. Citadel Energy Partners, LLC.*, Judge Kevin Carey extended a series of decisions involving LLCs to the limited partnership context, finding that creditors of a Delaware limited partnership are precluded from obtaining standing under provisions of the Delaware Limited Partnership Act, as are trustees of the limited partnership who have taken an assignment of claims under a plan of liquidation.

BACKGROUND

Citadel involved four debtors — a Delaware limited partnership, two North Dakota LLCs and a Wyoming LLC. The creditors committee filed an adversary proceeding asserting derivative breach of fiduciary duty and other claims against the debtors. The subsequently confirmed Chapter 11 plan created a liquidating trust and appointed a liquidation trustee to "pursue and prosecute" estate causes of action. After the liquidation trustee was substituted in as plaintiff for the committee, the debtors moved to dismiss the derivative fiduciary duty claims by challenging the liquidation trustee's standing.

Embracing the well-established rules of statutory interpretation, the court began by examining the plain language of the Delaware Limited Partnership Act. In particular, the statute, 6 Del. C. § 17-1002, provides that a "Proper Plaintiff" in a derivative action "must be a partner or an assignee of a partnership interest." The court concluded that the statute was dispositive and held that "creditors of limited partnerships lack standing to sue derivatively on behalf of an LP" and that the creditors committee was not an assignee of a partnership interest. The court reached the same conclusion with respect to the debtor LLCs organized under North Dakota and Wyoming law, finding that their respective derivative statutes were substantially

similar to the Delaware law.

The court's holding relied on the comparable provision of the Delaware Limited Liability Act and two recent, similar cases: Judge Kevin Gross' 2018 decision *In re HH Liquidation, LLC* and Judge Christopher S. Sontchi's 2018 decision *In re PennySaver USA Publishing, LLC*, both of which held that an unsecured creditors committee of a Delaware LLC lacked standing to bring derivative claims for breaches of fiduciary duties. The court noted that the innate flexibility of LLCs under Delaware law and complex relationships that govern such a legal arrangement supported its holding because Delaware law encourages sophisticated parties to achieve "bargained for rights and principles of freedom of contract." The court also noted that "distinguishing between insolvent corporations, where creditors can sue derivatively, and insolvent LLCs, where they cannot, does not produce an absurd result as different legal principles apply to different corporate entities."

The liquidation trustee argued that under the plan of liquidation, all estate claims, including those initiated by the creditors committee or the debtors themselves, as well as yet-to-be-filed claims, were assigned to the liquidating trust. The court recognized that assignment of a contract permits an assignee to step into the shoes of the assignor, but it does not change the fact that the creditors committee lacked standing to pursue the derivative causes of action, because it was neither a partner or member of any debtor. Accordingly, the court concluded that the liquidation trustee lacked standing as well.

IMPLICATIONS

Citadel serves as an important link in the developing body of Delaware bankruptcy court opinions addressing whether and when derivative claims on behalf of Delaware alternative entities may be asserted in bankruptcy. The three sitting Delaware bankruptcy judges who have written on these issues analyze them consistently and provide essential clarity for these situations.

While bankruptcy opinions are not binding on other bankruptcy judges, the cluster of opinions signifies a consensus within the court and the possibility of further consensus among other courts, especially when dealing with entities organized under states maintaining similarly worded alternative entity statutes to Delaware. ■

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