Eye on Bankruptcy Course Materials Covering June 2015

This webinar is the fourth in a series of monthly presentations designed to keep you up-to-date on changes in bankruptcy and restructuring; track recent filings, motions, and decisions; and implement revisions to bankruptcy rules and forms. From detailed intelligence on federal and bankruptcy court dockets and opinions, to step-by-step guidance through all levels of the bankruptcy process from American Bankruptcy Institute (ABI) treatises, these ABI and Bloomberg BNA co-sponsored webinars will help bankruptcy attorneys and practitioners gain a deeper understanding of bankruptcy law issues.

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U.S. Supreme Court

Commentary:

The Supreme Court's held 6-3 that lawyers may not be compensated for successfully defending fee applications. According to Justice Thomas, Section 330 does not explicitly abrogate the American Rule, which evidently has the same status as a statute.

High Court Denies Compensation for Defending Fees in Bankruptcy

The U.S. Supreme Court ruled that attorneys can't be paid for defending their fee requests in a bankruptcy case because the Bankruptcy Code ``does not explicitly overrule the American Rule," which requires each side to pay its own lawyers.

Writing for himself and four other justices, Justice Clarence Thomas said on June 15 the American Rule is a ``bedrock principle" to be employed ``unless a statute or contract provides otherwise."

Justice Sonia Sotomayor reached the same result in a short concurring opinion, saying there is no ``textual" support for shifting the burden of fees to the bankrupt company.

Justice Stephen G. Breyer dissented, in an opinion joined by Justices Ruth Bader Ginsburg and Elena Kagan.

The dissenters criticized the majority for requiring the statute to explicitly overrule the American Rule. They said an earlier high court decision on fee shifting had no such requirement.

The appeal arose from the Chapter 11 reorganization of Asarco LLC. Two Texas firms represented the company in successfully prosecuting a fraudulent-transfer suit worth $7 billion to $10 billion against the metal producer's Mexican owner, Grupo Mexico SAB. As a result of the victory, all creditors were paid in full.

Base Compensation

The bankruptcy judge awarded $113 million in fees to Houston-based Baker Botts LLP and $7 million to Corpus Christi-based Jordan, Hyden, Womble, Culbreth & Holzer PC as their base compensation.

The bankruptcy court also granted bonuses of $4.1 million and $125,000 to the firms and gave them $5 million and $15,000, respectively, in reimbursement for successfully defending their fee requests from attack by Grupo Mexico.

That money, like their other fees, would come from the Asarco bankruptcy estate.

The U.S. Court of Appeals in New Orleans ruled categorically in April 2014 that bankruptcy lawyers can never be paid for defending their fee requests unless opposition was mounted in bad faith. Thomas upheld that result.

Thomas cited Section 330(a)(1) of the Bankruptcy Code, which allows ``reasonable compensation for actual and necessary" expenses. He said that provision ``neither specifically nor explicitly authorizes courts to shift the costs" from one side to the other.

`Disinterested Service'

The dissenters said the statute does allow fee shifting on the theory that defense of compensation is among the underlying services that bankruptcy courts are allowed to pay. Thomas said time spent defending fees was not a ``disinterested service" performed in the administration of the bankruptcy.

The government side with the law firms, contending that defense fees must be paid so compensation for other services isn't diluted.

During oral argument in February, Sotomayor observed on two occasions that defending fees benefits only the lawyer, not the bankrupt estate. Kagan tipped her hand by saying defense costs are merely one aspect of what's a ``reasonable" fee permitted by Section 330 of the Bankruptcy Code. Similarly,

Ginsburg said she saw no difference between seeking fees in the first place and defending fees later.

Scalia said at oral argument that a law firm that sues for its fees outside of bankruptcy pays its own costs of collection under the American Rule.

The case is Baker Botts LLP v. Asarco LLC, 14-103, U.S. Supreme Court (Washington).

Published June 15, 2015

Commentary:

The Supreme Court ruled by 6/3 that express consent waives "Stern" issues. By 5/4, the justices held that implied consent or waiver dispenses with Stern objections.

Evidently, the Chief Justice didn't really mean in Stern that the opinion was narrow and would not much affect the distribution of work. I wonder if those words were include in Stern to gain a fifth vote from Justices Kennedy or Alito.

Justices Say Bankruptcy Courts Can Rule If Parties Consent

The nation's bankruptcy courts remain in business thanks to a ruling by the U.S. Supreme Court that they can make final decisions in some disputed matters.

Justice Sonia Sotomayor, writing for herself and four other justices, ruled on May 26 that parties, if they consent, can let bankruptcy judges make final decisions on matters that otherwise would only be within the purview of federal district judges.

She also ruled for the majority that a litigant can waive or give implied consent to a decision by a bankruptcy judge on a question that would otherwise belong in district court.

Justice Samuel Alito concurred in the majority's decision that actual consent can waive the right to a district court suit. Alito wouldn't have decided whether consent can be implied.

Chief Justice John G. Roberts Jr. dissented, joined by Justice Antonin Scalia. Justice Clarence Thomas wrote a separate dissent.

The case, argued in January, stemmed from a 2011 high court decision, known as Stern, that a bankruptcy judge can't make a final ruling on some types of claims based on state law. The Supreme Court used the latest case to decide whether parties can consent to a final ruling in bankruptcy court in a case that otherwise fell within the ambit of the earlier decision.

Overburdened Courts

During oral arguments, much more than consent seemed at issue. Some justices seemed to suggest that bankruptcy courts can't constitutionally make decisions based even in part on state law, meaning bankruptcy courts largely would have been put out of business and already overburdened district judges would have had to take up the slack.

The constitutional issue arose because bankruptcy judges have neither life tenure nor protection from having their salaries lowered. District judges have life tenure and salary protection. The two categories of judge are covered by different articles of the Constitution.

The U.S. Court of Appeals in Chicago had ruled that parties can't consent to final adjudication by bankruptcy courts in cases covered by Stern. Had the Supreme Court agreed, parts of the system of federal magistrate judges might also have been found unconstitutional.

Sotomayor ruled that someone can waive a ``personal right'' to a decision by a district judge. But, she said, that waiver isn't possible when a ``structural issue is implicated in a given case.''

`Emasculating' Courts

A structural concern would arise if Congress tried to transfer jurisdiction away from district courts ``for the purpose of emasculating constitutional courts,'' she said.

Sotomayor found no structural issues in allowing bankruptcy courts ``to decide claims submitted to them by consent,'' as long as district courts ``retain supervisory authority over the process.'' Decisions must be made ``with an eye to the practical effect,'' she said, alluding to the potential burden on district courts.

``Express consent'' isn't required, according to the majority ruling, as nothing in the Constitution demands it.

Sotomayor sent the case back to the lower courts to decide whether consent or waiver in the case at hand was ``knowing and voluntary.''

Not allowing consent, Sotomayor said, would be inconsistent with Stern, which said it was a ``narrow'' decision that didn't change the division of labor between district courts and bankruptcy courts ``all that much.''

Different Tack

Alito reached the same result by different means. He said the case was no different from arbitration, in which the parties can consent to a decision by a non-federal body that will be enforced later in federal courts. While consent can be express, he said he wouldn't have decided whether it can be implied.

While dissenting on the consent issues, Roberts made a pronouncement that expands the powers of bankruptcy judges in one respect. The chief justice said a bankruptcy court has the power to make a final decision on disputed ownership of property as long as there are no adverse claims by third parties. The majority expressed ``no view'' on that question.

The chief justice, like Thomas, held that the case implicated structural issues and that the exercise of power in bankruptcy court even with consent was unconstitutional.

The case in the high court is Wellness International Network Ltd. v. Sharif, 13-935, U.S. Supreme Court (Washington). The case in the appeals court was Wellness International Network Ltd. v. Sharif, 12-1349, U.S. Court of Appeals for the Seventh Circuit (Chicago).

Published May 26, 2015

Commentary:

The Supreme Court is primed to overrule Dewsnup, judging from the Court's June 1 opinion in Caulkett.

The bank filed gobs of cert petitions in cases from the Eleventh Circuit identical to Caulkett. Those petitions were being held in abeyance pending the Caulkett opinion.

If the respondent-consumers in those cases modify their responsive briefs and ask the Court to overruled Dewsnup, the Court might grant cert before the end of the term, or when the new term begins in October.

Supreme Court Is Ready to Overrule 1993 Case Protecting Lenders

The U.S. Supreme Court all but said it's got the votes to overrule its much-criticized 1993 decision involving the treatment of second mortgages in bankruptcy.

The court this week handed down an opinion that prevents people in Chapter 7 bankruptcy from voiding the second mortgage on a home whose value won't even cover the first mortgage. Eliminating an entirely underwater mortgage is called lien-stripping.

In its 1993 decision in Dewsnup v. Timm, the court ruled that a person in Chapter 7 bankruptcy can't ``strip down'' the amount of a subordinate mortgage to reflect the value of the property when the home is worth more than the first mortgage but less than the two mortgages combined.

Because the parties in the latest case didn't ask the justices to overrule Dewsnup, the court let the 1993 case stand. But the overall opinion and a footnote suggest that the earlier decision has lost majority support.

The U.S. Court of Appeals in Atlanta is alone among circuit courts in allowing a Chapter 7 bankrupt to lien-strip when a home is worth less than the first mortgage. Other appeals courts considering the issue have held that Dewsnup means such lien-stripping is impermissible.

`Straightforward Reading'

Writing for a unanimous court June 1, Justice Clarence Thomas held that the case was governed by Section 506(d) of the Bankruptcy Code, which says a claim is considered secured to the extent there is value in the collateral.

Under what he called a ``straightforward reading of the statute,'' Thomas said, the bankrupt ``would be able to void the bank's liens,'' thereby allowing lien-stripping in Chapter 7.

``Unfortunately for the debtors,'' however, the Supreme Court in Dewsnup already decided the meaning of the statute and ``resolved the question presented here,'' Thomas said.

Based on ``policy considerations and its understanding'' of law before adoption of the Bankruptcy Code in 1978, the court in Dewsnup said a claim is secured whether there's value in the collateral or not, according to Thomas.

Thomas said the homeowners wanted the court to limit Dewsnup to when there was some value in a subordinate mortgage. He ``declined to adopt that distinction'' and said limiting Dewsnup ``would not vindicate Section 506(d)'s original meaning, and it would leave an odd statutory framework in place.''

Early Criticism

Justices Anthony M. Kennedy, Stephen G. Breyer, and Sonia Sotomayor didn't join in the sole footnote in Thomas's opinion, which addressed criticism of Dewsnup. That footnote cited courts and commentators who assailed the 1993 decision ``from its inception.''

``Despite this criticism, the debtors have repeatedly insisted that they are not asking us to overrule Dewsnup,'' Thomas wrote in the footnote.

Dewsnup was a 6-2 decision, over a vigorous dissent by Justice Antonin Scalia, who was joined by

David Souter, now retired. Although he was already on the Supreme Court, Thomas didn't participate. Of the six justices in the Dewsnup majority, only Kennedy remains on the bench.

The latest case was argued on March 24, when Justice Elena Kagan said she agreed with Scalia's dissent in Dewsnup. Sotomayor said at the time that retaining a valueless mortgage interferes with bankruptcy's purpose in providing a ``fresh start.''

Homeowners can strip off or strip down second mortgages by filing in Chapter 13, rather than Chapter 7, but legal fees are higher in Chapter 13 and the bankrupt may have to pay some unsecured debt over five years. Companies in Chapter 11 can also wipe out valueless mortgages.

The cases are Bank of America v. Toledo-Cardona, 14-163, and Bank of America v. Caulkett, 13-1421, U.S. Supreme Court (Washington).

Published June 1, 2015

Circuit Splits

Commentary:

The Tenth Circuit widened the split on whether courts may use Section 105 rather than state law to recharacterize debt as equity.

Split Widens on Using Equity, Not State Law, to Recharacterize

The Denver-based U.S. Court of Appeals for the 10th Circuit handed down an opinion that is noteworthy in two respects.

First, the court widened an existing split among the circuits by holding that a bankruptcy court can recharacterize a claim using general principles of equity under Section 105 of the Bankruptcy Code. Second, the appeals court rebalanced facts found by the bankruptcy court and ruled that a claim should not have been recharacterized as equity.

The 2-1 decision on June 12 involved a man who made a highly speculative investment, buying a company for $500,000 and providing $3 million via secured debt. Using a 13-part, non-exclusive list of factors, the bankruptcy court decided that the secured claim should be recharacterized as equity. The Bankruptcy Appellate Panel upheld the bankruptcy court.

Reversing the lower courts, the majority opinion by U.S. Circuit Judge Paul J. Kelly Jr. parted company with sister circuits in San Francisco and New Orleans. Those courts ruled in 2013 and 2011, respectively, that state law, not general notions of equity in Section 105, must be used to recharacterize a claim as equity.

For discussions of those cases -- Fitness Holdings in San Francisco and Lothian Oil in New Orleans -- see the May 6, 2013, and Aug. 29, 2011, Bloomberg bankruptcy reports.

Kelly looked at the Travelers and Law decisions from the U.S. Supreme Court in 2007 and 2014, respectively. Those cases both disabled the bankruptcy court from using equitable principles to rewrite the Bankruptcy Code.

Neither high court case, Kelly said, dealt with recharacterization and thus didn't overrule Hedged-Investments, a prior 10th Circuit case permitting the use of Section 105 in recharacterizations.

Kelly said disallowance of a claim and recharacterization ``require different inquiries and serve different functions.'' He said recharacterization is ``part of a long tradition of courts applying the `substance over form' doctrine.''

Because recharacterizing a debt doesn't override another ``explicit mandate'' in the Bankruptcy Code, it isn't affected by the Law opinion.

Kelly's decision falls on the same side of the split as the Sixth Circuit in Cincinnati did in the Autostyle case.

Although he didn't overrule any of the lower court's fact findings, Kelly said the bankruptcy judge drew the wrong conclusions from them. He said there's ``nothing inherently improper'' in making loans to a ``struggling business.''

Kelly espoused a policy in favor of encouraging owners to attempt to salvage their businesses, especially when the owner may be the only person willing to make a loan. Courts should ``exercise caution'' when applying rules of recharacterization so owners aren't discouraged from lending a hand, he said.

Kelly also reversed the bankruptcy court for having equitably subordinated the loans. He said it's a remedy to be used ``sparingly.'' In the case before him, there was no ``unfairness'' required before equitable subordination is improper.

U.S. Circuit Judge Gregory A. Phillips dissented, saying it wasn't proper to reweight the factors. He would have recharacterized the debt as equity.

The case is Redmond v. Jenkins (In re Alternate Fuels Inc.), 14-3086, 2015 BL 186163, U.S. Court of Appeals for the 10th Circuit (Denver).

Published June 15, 2015

Commentary:

Kudos for Fifth Circuit Judge Carolyn King. She took on Richard Posner from the Seventh Circuit and won.

King noted that no other appellate court has followed Posner's 2000 opinion holding that "actual fraud" in Section 523(a)(2)(A) includes constructive fraud.

She consulted Prosser on Torts and other authorities to hold that actual fraud requires misrepresentation made to the person raising the claim plus reliance, neither of which exists in a typical constructive fraudulent transfer.

King on 5th Circuit Rejects Posner Opinion for the 7th Circuit

U.S. Circuit Judge Carolyn King of the U.S. Court of Appeals in New Orleans disagreed with U.S. Circuit Judge Richard A. Posner, her Chicago counterpart, over the ability of a creditor to bar discharge of a debt for ``actual fraud."

King's case involved a man who caused his company to transfer funds to himself. The man later went bankrupt. A creditor owed $164,000 sued in bankruptcy court to bar discharge of the debt under Section 523(a)(2)(A) of the Bankruptcy Code.

That section precludes wiping out a debt based money obtained for ``actual fraud."

The bankruptcy judge found that the property transferred from the company to the bankrupt was a constructive fraudulent transfer because it was made without adequate consideration. But the bankruptcy judge rejected the request to bar discharge of the $164,000 debt to the creditor.

The district court affirmed on the initial appeal, as did King for a three-judge panel of the Fifth Circuit in New Orleans.

The creditor based its argument largely on a 2000 Seventh Circuit opinion in McClellan v. Cantrell. In that case, Posner said a fraudulent misrepresentation isn't the only form of fraud making a debt nondischargeable under subsection (a)(2)(A).

King spent the better part of her May 22 opinion explaining why Posner was wrong. She pointed out that no appellate court has ever followed Posner on that issue.

Harking to the Prosser hornbook definition of actual fraud, King said it requires misrepresentation made by the bankrupt to the creditor and reliance by the creditor. King said there's no authority for the concept that actual fraud encompasses constructive fraudulent transfers.

Underlying King's conclusion was the fact that the bankrupt made no misrepresentations to the creditor.

Were the law as broad as Posner found, King said, ``other exceptions to discharge in the Bankruptcy Code may be rendered redundant by the McClellan majority's broad" definition of actual fraud.

The case is Husky International Electronics Inc. v. Ritz (In re Ritz), 14-20526, 2015 BL 162947, U.S. Court of Appeals for the Fifth Circuit (New Orleans).

Published May 28, 2015

The Circuits

Commentary:

Circuit Judge Richard Posner used a case involving a general contractor to expound on the standard for "recklessness" required in the wake of Bullock v. BankChampaign NA. Although evidence abounded to deny discharge under any standard, Posner's opinion tends in the direction of permitting an objective standard.

Posner Opinion Says Trust Fund Debt Always Nondischargeable

Circuit Judge Richard A. Posner penned an opinion on June 4 expounding on the meaning of a decision two years ago by the Supreme Court regarding evidence necessary to bar a bankrupt from shedding debt as a consequence of ``defalcation" while acting in a ``fiduciary capacity."

Posner's opinion seems to create an objective standard for finding ``recklessness." His decision appears to mean that any experienced contractor who doesn't pay subcontractors can't discharge the debt by filing bankruptcy.

In Bullock v. BankChampaign NA, the high court said that the bankrupt must have had knowledge that the conduct was improper or there was gross recklessness about the improper nature of the action, before a debt survives bankruptcy under Section 523(a)(4) of the Bankruptcy Code.

Posner's case involved a man who owned a company that built homes. He failed to pay subcontractors, in the process violating a Wisconsin statute which provides that money received for the homes is held in trust until subcontractors are paid.

A subcontractor sued and got a judgment for more than $500,000 before bankruptcy. The subcontractor sued in bankruptcy court, where a judge ruled that the debt wasn't discharged as a defalcation while acting in a fiduciary capacity. A district court upheld the ruling, and the owner appealed, unsuccessfully.

The owner testified that he knew about the Wisconsin law but didn't know about the provision regarding a trust fund. The law, however, doesn't require an actual segregation of money or creation of a trust account.

The owner had been in the homebuilding business for 40 years and had a college business degree. Posner said the trust-fund requirement was ``generally known in the industry." In addition, Posner said it ``was inconceivable that [the owner] did not know that proceeds of the sale of a home have to be held in trust."

Posner upheld the lower courts, not just because the owner ``should have known" about the trust-fund requirement. He said there ``was a permissible inference that he did know, or at least was playing ostrich."

Conscious disregard of risk, willful blindness, or gross negligence amount to recklessness and represent ``a mental state on which a finding of fraud can be based," Posner said in interpreting Bullock.

Posner said that evidence of ``recklessness abounds" and therefore upheld the lower courts.

The case is Stoughton Lumber Co. v. Sveum, 14-3339, 2015 BL 176212, U.S. Seventh Circuit Court of Appeals (Chicago).

Published June 5, 2015

Professor:

Generally speaking, marijuana businesses legal under state law have not been able to avail themselves of relief in federal courts. The Ninth Circuit created an exception.

Balancing the evil deeds, the circuit permitted a marijuana dispensary to bar discharge of a debt owed by a lawyer who stole from the business.

Stealing Is Worse than Selling Marijuana, Federal Court Rules

Stealing is worse than selling marijuana, according to the U.S. Court of Appeals in San Francisco.

A lawyer was on the board of a marijuana dispensary -- legal under California law but not under federal law. He was paid $5,000 a month to serve as counsel and was given $25,000 in cash to hold as a legal defense fund for the dispensary.

He absconded with the $25,000 and was sued. After the dispensary got a judgment, he filed for bankruptcy and was met with an objection to the discharge of the $25,000 debt under Section 523(a)(4) of the Bankruptcy Code for fraud while acting in a fiduciary capacity.

The bankruptcy court discharged the debt, saying the dispensary was guilty of unclean hands for selling marijuana in violation of federal law. The district court reached the same conclusion on the first appeal, but San Francisco's Ninth Circuit reversed.

U.S. Circuit Judge Michelle T. Friedland relied on a U.S. Supreme Court case called Yellow Cab for the proposition that the unclean-hands doctrine can't always allow a wrongdoer to retain the benefits of wrongdoing. She said that Ninth Circuit precedent doesn't apply unclean hands ``when to do so would frustrate a substantial public interest."

In her June 5 opinion for the three-judge panel, Friedland said stealing a client's money was a ``gross violation of general morality." To permit such conduct, she said, ``would undermine the public interest in holding attorneys to high ethical standards."

The judge noted that the lawyer, by serving on the board, also participated in the illegal activity. Thus, she said, illegal conduct must be attributed to both parties when weighing his wrongdoing.

The appeals court said the bankruptcy court abused its discretion by discharging the debt.

The case is Northbay Wellness Group Inc. v. Beyries, 13-17381, 2015 BL 177963, U.S. Court of Appeals Ninth Circuit (San Francisco).

Published June 9, 2015

Commentary:

Following a spate of questionable cross-border decisions at the circuit level, the Fifth Circuit, per Judge Haynes, took a broad reading of Section 1334(c)(1) and held that a court cannot abstain from a lawsuit that is even related to a Chapter 15 case.

Federal Court Must Hear Case Related to Cross-Border Bankruptcy

A federal court can't abstain and remand a suit to state court when a party is in a Chapter 15 cross-border bankruptcy, the U.S. Court of Appeals in New Orleans ruled on June 5.

Several pension funds filed suit in Louisiana state court against feeder funds affiliated with the Fletcher International Ltd. master fund that was in Chapter 11 bankruptcy in New York. The pension fund later joined a law firm as an additional defendant in the suit.

After the defendants removed the suit to federal court, the pension funds asked the district judge to abstain and remand the suit to state court. Meanwhile, the plaintiffs, through their liquidators in the Cayman Islands, filed petitions under Chapter 15, also in New York.

Only mentioning the Chapter 15 case but without analyzing its implications, the district judge abstained and remanded the suit to state court. The defendants appealed.

The existence of appellate jurisdiction was the first question for the Fifth Circuit in New Orleans because a remand order ordinarily isn't appealable. In her opinion for the three-judge panel, U.S. Circuit Judge Catharina Haynes said the case before her was one of the ``limited circumstance'' where there is a right of appeal.

The question on appeal revolved around Section 1334(c)(1) of the federal Judiciary Code, which says a court can abstain ``from hearing a particular proceeding'' in a bankruptcy case ``except with respect to a case under Chapter 15.''

Haynes said the issue on appeal was whether the statute excepts only the Chapter 15 case itself or the Chapter 15 case and anything related to it.

She opted for the broader meaning and ruled that the statute prohibiting abstention applies to the suit because it was related to the Chapter 15 bankruptcy.

Haynes reversed the district court for improperly abstaining and remanding the suit to state court. She sent the case back to the district court for further proceedings consistent with her opinion.

The case is Firefighters' Retirement System v. Citco Group Ltd., 14-30857, 2015 BL 178686, U.S. Court of Appeals for the Fifth Circuit (New Orleans).

Published June 9, 2015

Chapter 11 Cases

Commentary:

The Third Circuit held on May 21 in the Jevic, over a dissent, that a structured dismissal can avoid priorities "in a rare case." The court adopted the Second Circuit's rule from Iridium in 2007.

The virtually identical issue is pending in the Third Circuit in the LCI case which was argued the same day, Jan. 14, although before a different panel that included Thomas Ambro. The LIC case involved "gift" settlements.

Although Jevic thus becomes binding authority in LCI, we will wait to see when LCI comes down whether the two opinions differ to any degree or give grounds for rehearing en banc.

Appeals Court Says Settlement Can Skirt Mass-Firing Claims

In a split decision, the U.S. Court of Appeals for the Third Circuit in Philadelphia ruled that creditors can settle a lawsuit belonging to a bankrupt company and distribute proceeds in a so-called structured dismissal that violates bankruptcy priorities, but only ``in a rare case."

U.S. Circuit Judge Thomas M. Hardiman, writing for himself and another judge in a May 21 opinion, adopted the rationale embraced by its Manhattan sister court in a 2007 case called Iridium. The dissenter, U.S. Circuit Judge Anthony J. Scirica, concurred that Iridium is a correct statement of the law, but he differed in its application to the case on appeal.

The opinion is important because it came from the Third Circuit, which makes law governing Delaware, where many of the country's major bankruptcies are conducted. The split decision means the losing side might ask for rehearing before all active judges on the appeals court.

The dispute involved a trucking company that shut down before bankruptcy and completed liquidation in Chapter 11. The official unsecured creditors' committee sued and negotiated a settlement with the lender and owner setting aside some money for distribution to unsecured creditors. Scirica said the creditors were suing on a claim that belonged to the company and therefore was part of the bankrupt estate.

The bankruptcy court approved the settlement. The money was distributed to unsecured creditors, and the case was dismissed.

Workers who lost their jobs opposed the settlement and appealed because they got nothing from it. They asserted an unresolved $12 million claim from mass firings without the notice required by the so-called Warn Act. The workers said some $8 million were priority claims that should be paid in full under bankruptcy priorities before any distributions to general unsecured creditors.

After a district judge in Delaware upheld the lower court in January 2014, the workers turned to the Third Circuit, where they fared no better, despite convincing one of the three judges on the panel.

Hardiman first ruled that structured dismissals are permissible in Chapter 11. A structured dismissal ordinarily entails settlements and distributions followed by dismissal of the Chapter 11 case where confirming a plan isn't feasible.

He then addressed whether a structured dismissal can violate priorities of bankruptcy distribution.

Although he said it was a ``close call," Hardiman concluded that a structured dismissal bypassing the workers' claims was the ``least bad alternative" because anything else would have resulted in all remaining assets going to secured creditors.

The Bankruptcy Code, strictly speaking, doesn't impose the absolute priority rule on settlements. Still, the majority said, the policy underlying the rule ``applies in the settlement context." Consequently, settlements can't be approved that are devised ``by certain creditors in order to increase their shares of the estate at the expense of other creditors."

A court can approve a settlement disregarding priorities, the majority said, ``absent a showing that structured dismissal has been contrived to evade procedural protections and safeguards of the plan confirmation or conversion process."

Adopting the Manhattan circuit court's Iridium rule, Hardiman rejected the New Orleans-based Fifth

Circuit's ruling in Aweco, which imposed the absolute priority rule on settlements.

In his dissent, Scirica said the settlement ``undermined the Code's essential priority scheme'' and was ``at odds with the goals of the Bankruptcy Code.''

He said the settlement ``appears to constitute an impermissible end-run around'' the hurdles for emerging from Chapter 11.

Scirica said he wouldn't unwind the settlement. He would have required unsecured creditors to disgorge what they were paid and turn the money over to workers until their approved claims were paid in full.

The case is Official Committee of Unsecured Creditors v. CIT Group/Business Credit Inc. (In re Jevic Holding Corp.), 14-1465, U.S. Court of Appeals for the Third Circuit (Philadelphia). The opinion in district court was is Czyzewski v. Jevic Holding Corp., 13-104, U.S. District Court, District of Delaware (Wilmington).

Published May 21, 2015

Commentary:

District Judge John G. Koeltl in New York wrote a Lehman decision suitable for a law school textbook. He explained why the rules differ on when a claim arises against a debttor or by a debtor against a third party.

Lehman Creditor Isn't Excused from Filing Timely Claim

The bankruptcy of Lehman Brothers Holdings Inc. continues making law -- three years after the investment bank's Chapter 11 plan was confirmed.

The newest decision, from U.S. District Judge John G. Koeltl in New York, deals with constitutionally adequate notice and the time when claims arise.

Lehman signed a debt service reserve fund agreement with a customer in 1998. Its bankruptcy 10 years later was an event of default.

The customer sent Lehman a notice after bankruptcy terminating the agreement and calculating the amount it was owed. The customer didn't file a claim, for $1.3 million, until a month after Lehman implemented its Chapter 11 plan in March 2012.

The bar date, or last day for filing a claim, was in September 2009.

The customer contended that the bar date didn't apply because the claim didn't arise until after bankruptcy. The bankruptcy judge disagreed, and so did Koeltl on appeal.

Given the bankruptcy definition of ``claim," the customer's claim arose in 1998 on signing the contract. The fact that the claim was only contingent didn't make it any less a claim at the time of bankruptcy.

Koeltl said that the occurrence of the contingency, Lehman's bankruptcy, ``does not transmogrify the claim into a postpetition claim." Consequently, the customer was required to, but didn't, file a claim by the bar date.

Notice of the bar date was mailed to the customer. Koeltl said that the failure to file a timely claim was only the customer's responsibility and wasn't caused by any lack of adequate notice. As a result, due process rights weren't violated.

The case is Conway Hospital Inc. v. Lehman Brothers Holdings Inc., 14-cv-7026, 2015 BL 141891, U.S. District Court, Southern District New York (Manhattan).

Published May 15, 2015

Commentary:

A nifty ResCap opinion deals with the date for commencement of a lawsuit where Section 108 is implicated. The case is probably correct, although a reversal wouldn't be surprising.

Technicality Saves ResCap Lawsuits from Dismissal as Untimely

Lawsuits on behalf of creditors of Residential Capital LLC survived thanks to a technicality of Section 108(a) of the Bankruptcy Code, which extends statutes of limitations by two years for companies in bankruptcy.

ResCap implemented a Chapter 11 plan in December 2013 and sued mortgage-loan originators on May 13, 2014, to obtain recoveries for distribution to creditors. It's suing lenders for breach of contract and indemnification for selling mortgages that violated underwriting standards.

Under Minnesota's six-year statute of limitations, the time for filing the suits would have expired during ResCap's Chapter 11 case. The suits were filed just before the two-year extension would have elapsed under Section 108.

The defendants filed motions to dismiss based on Minnesota law providing that a lawsuit is commenced for statute of limitations purposes when the summons is served, not when the complaint is filed. Applying state law, lawsuits governed by Minnesota law would have been untimely, requiring dismissal.

U.S. District Judge Susan Richard Nelson found a loophole to keep the suits alive, thanks to Section 108. To deny dismissal motions, she had to find an exception to the Supreme Court's 1980 decision in Walker v. Armco Steel.

At first blush, Walker seemed dispositive and appeared to require dismissal because it teaches that state law on service of process in a diversity case is part of the statute of limitations and takes precedence over federal procedural Rule 3, which commences a case on the filing of a complaint.

But Nelson said timeliness in the ResCap cases isn't covered by the state statute of limitations. Instead, it's governed by Section 108, a federal statute. For that reason, she said Walker is ``distinguishable'' and inapplicable.

ResCap's suits survived on other grounds.

Jurisdiction in federal court was based on both diversity jurisdiction and bankruptcy jurisdiction under Section 1334 of the Judiciary Code, as related to a bankruptcy.

Walker also wasn't applicable, Nelson said, because that case didn't have Section 1334 as an alternative basis for jurisdiction. She cited Walker as saying that its rule wouldn't apply in the face of a ``governing federal rule.''

The case is In re RFC and ResCap Liquidating Trust Litigation, 13-cv-3451, U.S. District Court, District of Minnesota (Minneapolis).

Published May 21, 2015

Commentary:

Bankruptcy Judge Benjamin Goldgar wrote an eminently sensible opinion in the Caesars Chapter 11. For states that allow classic retainers, the lawyers are free in effect to draw down the retainer after an involuntary petition is filed.

Goldgar also held that representing a portfolio company of the debtor's owner is not an automatic violation of the disinterestedness test.

Caesars Opinion Protects Lawyers' Retainers in Big Bankruptcies

Casino owner Caesars Entertainment Operating Co. can keep its chosen attorneys after a judge issued an opinion assuring bankruptcy lawyers they can draw down retainers even after creditors file an involuntary bankruptcy petition.

The ruling is also good news for bankruptcy lawyers because it allows a law firm for a bankrupt company to have simultaneous representations of unaffiliated companies that have common ownership with the bankrupt company.

Caesars hired Kirkland & Ellis LLP months before the involuntary Chapter 11 petition filed by some of the casino company's creditors on Jan. 12. Three days later, Caesars put itself into Chapter 11 voluntarily in Chicago.

Some junior creditors and bondholders oppose Caesars' initiatives in Chapter 11, and are challenging transactions made in August that transferred assets and terminated guarantees by the non-bankrupt parent.

The official committee representing second-lien noteholders objected to Kirkland's engagement by Caesars. U.S. Bankruptcy Judge Benjamin A. Goldgar rejected the complaints in an opinion filed on May 28.

Kirkland received several payments in advance of bankruptcy that it characterized as a ``classic retainer'' in which the money was earned entirely on receipt and became the lawyers' property.

As it turned out, Kirkland drew $7.2 million against the retainers after the involuntary petition but before the voluntary filing. Nonetheless, the firm said it was still ``ahead'' at the time of bankruptcy and thus wasn't a creditor.

The noteholder committee contended it was a so-called security retainer and that drawing against it violated the automatic bankruptcy injunction prohibiting action against a debtor's property.

Goldgar disagreed, although he said they were so-called hybrid retainers, not ``classic'' retainers. Because the retainers were Kirkland's property, the firm wasn't adverse to Caesars, was within its right to drawn down the retainers and is eligible to serve as counsel in Chapter 11.

While the judge found that Kirkland violated Rule 1.15(c) of the Illinois Rules of Professional Conduct governing lawyers' ethics, Caesars is sophisticated and was represented by inside counsel in negotiating the retainer. He said it was also ``worth noting'' that the company wasn't complaining about the retainer.

The noteholders also argued that Kirkland represents several unaffiliated companies owned by Caesars' majority shareholders. He said there was ``no evidence'' that those engagements ``would influence Kirkland's representation.''

The case is In re Caesars Entertainment Operating Co. Inc., 15-01145, U.S. Bankruptcy Court, Northern District of Illinois (Chicago).

Published June 1, 2015

Fees

Commentary:

The Supreme Court could have another bankruptcy fee case in the next term.

As we reported in February, the Eleventh Circuit spilt with the Ninth and held that the bankruptcy court, not just the appellate court, has an ability to award fees for appellate defense of dismissal of an involuntary petition against an individual.

The losing side filed a motion for rehearing en banc in the circuit. No judge on the Eleventh wanted even a vote on rehearing.

Another Bankruptcy Fee Case May be Headed to U.S. Supreme Court

The U.S. Supreme Court is likely to have another case dealing with lawyers' fees in bankruptcies.

In late February, the justices heard arguments in a dispute over whether attorneys representing bankrupt companies can recover fees for successfully defending their fees from attack. The high court will decide that case by end of June when the term ends. Judging from oral arguments, the odds favor barring a bankrupt company from being forced to pay a lawyer's defense of fee requests.

The new case comes from the U.S. Court of Appeals in Atlanta, where a three-judge panel ruled in February that bankruptcy judges have power to require creditors to pay an individual bankrupt's attorneys' fees incurred on appeal in upholding the dismissal of an involuntary bankruptcy petition.

The February opinion by the Atlanta court differed from a prior ruling on the same issue by its sister court in San Francisco. The Supreme Court is more prone to allowing appeals when lower courts reached diverging opinions.

If the high court takes the case, perhaps the justices will be more sympathetic when the benefit goes to a person in bankruptcy as much as the lawyer.

The losing side in the Atlanta case sought rehearing from all active judges on the appeals court. That court denied rehearing on May 18, with none of the judges even wanting a vote to decide about granting rehearing.

Denial of rehearing starts the clock ticking on the time for the losing side to request a final appeal in the Supreme Court.

The losing lender argues that only an appellate court has the power to award fees. The individual who won in Atlanta can oppose a Supreme Court appeal by arguing that the split isn't well developed because only two circuits have addressed the issue. For details on the panel's opinion from February, click here for the March 2 Bloomberg bankruptcy report.

Peter Levitt of Miami, the lawyer who lost the Atlanta appeal, didn't return a call seeking comment.

The case is DVI Receivables XIV LLC v. Rosenberg (In re Rosenberg), 13-14781, U.S. U.S. Court of Appeals for the 11th Circuit (Atlanta).

Published May 20, 2015

Consumer Cases

Commentary:

Chief Bankruptcy Judge Cecelia Morris in the SDNY was upheld in district court on an important case where she ruled that a Chapter 13 debtor need only show the value of the property and allege the amount of the first-lien debt to justify stripping off a subordinate mortgage. She and the district court rejected the notion that the debtor must also provide the details required when a mortgage lender files a proof of claim.

The case is important because debtors usually won't have the information required on a claim form. Had the subordinate lender's theory prevailed, most debtors would be unable to strip off mortgages without significant expense and delay and still might fail if the senior lender were uncooperative or could not locate required documents.

Ingenious Strategy Files to Prevent Stripping Second-Mortgage

A junior mortgage lender mounted an ingenious, albeit futile, bid to prevent a bankruptcy court from stripping off a lien when the value of the property was less than the first mortgage debt.

A bankrupt couple in Chapter 13 initiated proceedings to strip off, or turn a second mortgage loan into an entirely unsecured debt because the property was worth less than the first mortgage.

Because the holder of the first mortgage hadn't filed a claim, and wasn't required to do so except to preserve an unsecured claim, the couple filed a claim on behalf of the senior lender.

The junior lender objected to the senior mortgage claim, contending it didn't contain all the details required by bankruptcy rules for claims on home mortgages.

Chief U.S. Bankruptcy Judge Cecelia Morris in Poughkeepsie, New York, ruled that information about the first mortgage was sufficient and proceeded to strip off the second mortgage.

On appeal, U.S. District Judge Cathy Seibel in White Plains, New York, upheld Morris in that respect.

Seibel said that showing the amount of the first mortgage and the value of the home was enough to strip off the second.

The opinion is important because mortgage lenders aren't required to file claims in Chapter 13 to maintain the enforceability of their liens. Homeowners in most cases won't have information sufficient to provide the details demanded by bankruptcy rules when a mortgage lender files a claim.

Stripping off a second mortgage would become impossible if bankrupts in Chapter 13 were required to provide as much detail as a senior mortgage lender.

The case is Green Tree Servicing LLC v. Wilson (In re Wilson), 14-cv-9543, 2015 BL 179802, U.S. District Court, Southern District of New York (White Plains).

Published June 10, 2015

Commentary:

Good news for a married debtor with a non-filing spouse! Less than complete disclosure of the non-filing spouse's finances is required for the debtor to confirm a Chapter 13 plan.

Little Information Required from Non-bankrupt Spouse to Confirm

Knowing a non-bankrupt spouse's monthly expenses isn't a prerequisite for confirming the bankrupt spouse's Chapter 13 plan, according to a May 20 opinion by U.S. District Judge Patrick J. Duggan in Detroit.

In her Chapter 13 papers, the bankrupt wife disclosed that her husband, a Detroit bus driver, earned about $2,000 a month and contributed $600 a month to household expenses. The bankruptcy judge, over the Chapter 13 trustee's objection, confirmed a plan under which the wife would pay $1,650 a month for five years.

The trustee appealed and lost.

The trustee argued that the plan shouldn't have been confirmed without disclosing the non-bankrupt husband's monthly expenses.

Duggan distinguished cases in which confirmation had been denied when there was no information about the non-bankrupt spouse's income and expenses.

Knowing the husband's income and contribution to household expenses was enough for the judge to find good faith and other requisites for confirmation, given the deference an appellate court gives to the lower court's findings of fact.

The case is Ruskin v. Blackshear (In re Blackshear), 14-14399, U.S. District Court, Eastern District of Michigan (Detroit).

Published May 26, 2015

Commentary:

The Eighth Circuit, more generous than the BAP, allowed a "public assistance benefit" exemption for the federal Additional Child Tax Credit even though higher income individuals sometimes might be eligible.

The circuit looked at the intent of Congress, instead of employing a plain meaning approach when the statutory language was unhelpful. The opinion harkens back to the good old days when opinions were replete with committee reports and statements from legislators.

Generous Circuit Court Permits Exemption for Child Tax Credit

The St. Louis-based U.S. Court of Appeals for the Eighth Circuit is more generous than the circuit's Bankruptcy Appellate Panel when it comes to giving lower-income bankrupts an exemption for the federal Additional Child Tax Credit.

The June 2 opinion by the Eighth Circuit is also noteworthy because it employs a little-seen exploration of legislative history in an era when ``plain meaning" is the vogue in statutory interpretation.

A woman in Chapter 13 claimed that a refund attributable to a child tax credit qualified as ``public assistance benefit" that's an exempt asset under Missouri law. The bankruptcy judge rejected the exemption and was upheld by the appellate panel in December 2013.

But U.S. Circuit Judge Michael J. Melloy reversed the lower courts and allowed the exemption.

The lower courts focused on the original version of the statute and concluded that it wasn't a public benefit because some higher-income people might qualify. Melloy instead focused on amendments over the past 15 years showing that ``the tax credit has been modified to benefit low-income families."

Analyzing statements made by lawmakers along with the amendments themselves, he said the ``intent of the legislature" appears ``to overwhelmingly benefit low-income families."

Writing for himself and one other circuit judge, Melloy permitted the exemption even though higher-income individuals sometimes might qualify for the tax refund.

U.S. Circuit Judge James B. Loken wrote a short opinion reaching the same result. Loken adopted the reasoning employed by U.S. Bankruptcy Judge Arthur B. Federman in Kansas City in a case called Corbett.

For more on the appellate panel's opinion, click here for the Dec. 26, 2013, Bloomberg bankruptcy report.

The case is Hardy v. Fink (In re Hardy), 14-1181, U.S. Court of Appeals for the Eighth Circuit (St. Louis).

Published June 2, 2015

Commentary:

If a trustee or a trustee's agent defames someone, the Eleventh Circuit holds that the suit falls within the protection of the venerable Barton doctrine so long as the tort was committed in the administration of the estate, as opposed to the day-to-day operations of the business.

Defamation Suit Held Within Protection of the Barton Doctrine

An alleged defamation that occurred as part of the administration of a bankruptcy is protected by the 1881 U.S. Supreme Court decision in Barton v. Barbour, the U.S. Court of Appeals in Atlanta ruled.

During a Chapter 11 case, the court approved hiring a lawyer to serve as the company's inside general counsel. The company issued a report that someone found defamatory.

After the conclusion of the bankruptcy, that person sued the lawyer in state court, raising defamation claims under state law. The bankruptcy court and the district court both ruled that the suit was barred by Barton, which requires obtaining court permission before suing a trustee.

Writing for a three-judge appeals panel, U.S. Circuit Judge Bobby R. Baldock said the court's precedents hold that investigators and lawyers hired by a trustee are covered by Barton. The same applies to a lawyer hired by a bankrupt company, Baldock said.

The plaintiff said his suit fell within an exception to Barton applicable to ``actions redressing torts committed in furtherance of the debtor's business,'' such as a ``negligence claim in a slip and fall case'' when the trustee is running a retail store.

Baldock said the defamation suit didn't come within the exception because it was in furtherance of the administration of the bankrupt estate, not ``day-to-day operations.''

Baldock is a judge on the U.S. Court of Appeals in Denver. He sat on the Atlanta panel by designation. The opinion won’t be officially published.

The case is Coen v. Stutz (In re CDC Corp.), 14-13133, U.S. Court of Appeals for the 11th Circuit (Atlanta).

Published June 12, 2015

Indian Law

Commentary:

A Michigan district judge took a broad reading of the Supreme Court's most recent sovereign immunity opinion regarding American Indians. Consequently, the district judge differed with some lower courts and held that Indian tribes fall within the definition of "governmental unit" and are therefore broadly exempt from fraudulent transfer suits.

Indian Tribe Gets Special Expansive Brand of Sovereign Immunity

An American Indian tribe has sovereign immunity barring a fraudulent transfer suit in bankruptcy court, even though the Bankruptcy Code doesn't use the words ``Indian tribe," U.S. District Judge Paul D. Borman in Detroit ruled on June 9.

The Sault St. Marie Tribe of Chippewa Indians owned the Greektown casino in Detroit, which went bankrupt in 2008. A litigation trustee sued the tribe, claiming it got $177 million without adequate consideration.

The tribe filed a motion to dismiss the suit, invoking sovereign immunity. The bankruptcy judge denied the motion. The tribe appealed.

The case turned on Section 106 of the Bankruptcy Code, which waives sovereign immunity for fraudulent-transfer suits, as long as the putative government falls within the definition of ``governmental unit" in Section 101(27). While an Indian tribe is not specifically listed, that section defines governmental unit to include ``other foreign or domestic government."

The casino's trustee argued the tribe fell within the definition because it was both domestic and a government. The trustee pointed to lower federal courts that reached the same conclusion in finding a statutory waiver of an Indian tribe's sovereign immunity.

Borman was chiefly guided by the U.S. Supreme Court's 2014 opinion in a case known as Bay Mills. He said that decision indicates the bankruptcy court's finding of a statutory waiver of sovereign immunity didn't give ``sufficient consideration to the special brand of sovereign immunity that Indian tribes enjoy."

There was no statutory waiver of sovereign immunity because Borman said he didn't have ``perfect confidence" that Congress meant the words in Section 101(27) to ``clearly, unequivocally and unmistakenly" waive Indian sovereign immunity.

Although Borman reversed the bankruptcy court and said the tribe was entitled to dismissal on the theory of statutory waiver, he remanded the case for the lower court to decide whether the tribe waived immunity by participating in the bankruptcy.

The appeal is Buchwald Capital Advisors LLC v. Papas (In re Greektown Holdings LLC), 14-14103, 2015 BL 15241, U.S. District Court, Eastern District Michigan (Detroit). The bankruptcy is In re Greektown Holdings LLC, 08-53104, U.S. Bankruptcy Court, Eastern District Michigan (Detroit).

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