



BANKRUPTCY INSTITUTE 2019



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- The design, promotion and administration of cooperative programs in legal research, to the end of furtherance and betterment of the administration of justice in Pennsylvania and elsewhere.
- The development, promotion and administration of cooperative programs for continuing legal education and education of the interested public in law and related subjects.

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Foreword

PBI is proud to present our 24th **Annual Bankruptcy Institute**. Each year this program receives rave reviews for its outstanding topics, speakers, and updates on recent developments in bankruptcy law. This year's program features bankruptcy judges from the Middle and Eastern Districts of the Bankruptcy Courts of Pennsylvania, as well as Delaware, New Jersey and a retired judge from the Western District of Pennsylvania.

Our sincere gratitude is extended to our dedicated course planning committee, without whom this program would not have been possible. The depth and quality of this annual seminar are attributable to their dedication and expertise. The distinguished members of our committee are:

For the Eastern District of PA: **Hon. Eric L. Frank, U.S. Bankruptcy Court for the Eastern District of Pennsylvania, Philadelphia; Anne E. Swartz, Esq., McCabe Weisberg & Conway, LLC, Philadelphia; James C. Vandermark, Esq., White and Williams, LLP, Philadelphia; and Jeremiah J. Vandermark, Esq., Saul Ewing Arnstein & Lehr, LLP, Philadelphia.**

For the Middle District of PA: **Hon. Henry W. Van Eck, U.S. Bankruptcy Court for the Middle District of Pennsylvania, Harrisburg; Kara K. Gendron, Esq., Mott and Gendron Law, Harrisburg; and Melissa L. Van Eck, Esq., Pennsylvania Office of the Attorney General, Harrisburg.**

Our gratitude is also extended to our incredible faculty, each of whom has volunteered their time to author the course materials and/or to address our audience on topics about which they are extremely knowledgeable. They are to be commended for their tremendous dedication and for their commitment to their colleagues and to continuing legal education. A biographical sketch of each of the faculty follows this Foreword and we invite you to read about all of our great volunteers.

On behalf of the lawyers who will benefit from the tremendous contribution of time and expertise made by the Bankruptcy Institute faculty, we offer our deepest appreciation to all of our planners, speakers and authors.

Pennsylvania Bar Institute
David Arena, Program Manager

September 2019

Biographies

PLANNING TEAM

Hon. Eric L. Frank

Judge Frank was appointed to the U.S. Bankruptcy Court for the Eastern District of Pennsylvania in February 2006 and served as Chief Judge of the court from March 2013 to February 2018. Judge Frank received his B.A. from the State University of New York at Binghamton in 1973 and his J.D. from the University of Pennsylvania Law School in 1976, where he served on the Law Review. After graduating law school, he served as a law clerk to the late Justice Samuel J. Roberts of the Pennsylvania Supreme Court and, in 1986-87 while on a one year sabbatical, he served as law clerk to U.S. Bankruptcy Judge Bruce I. Fox. As a practitioner, he was a shareholder in DiDonato and Winterhalter, P.C., a partner in Miller, Frank & Miller and a supervising attorney at Community Legal Services, Inc., all in Philadelphia. He participated in both consumer and commercial cases and was counsel in several cases that were decided by the U.S. Supreme Court and the U.S. Court of Appeals for the Third Circuit. From 1998 to 2005, Judge Frank served as a member of the Federal Judicial Conference Advisory Committee on the Federal Rules of Bankruptcy Procedure and was Chair of the Consumer Subcommittee that initiated the numerous rules and forms amendments initially promulgated in connection with the implementation of the 2005 BAPCPA amendments to the Bankruptcy Code. He is a past Chair of the Steering Committee of the Eastern District of Pennsylvania Bankruptcy Conference, a past President of the Board of Directors of the Consumer Bankruptcy Assistance Project in Philadelphia, which provides referrals and representation in Chapter 7 bankruptcy cases on a pro bono basis for eligible, indigent persons, and continues to serve as Contributing Author to the treatise *Collier on Bankruptcy*.

Hon. Henry W. Van Eck

Judge Van Eck was born in Ann Arbor, Michigan. He received his bachelor of science in Political Science from Susquehanna University in 1995 and his Juris Doctor, *cum laude*, from Widener University School of Law in 1998 where he served as a senior editor for the Widener Journal of Public Law. After completing law school, Judge Van Eck joined the Harrisburg law firm of Cunningham & Chernicoff, P.C., where he began the practice of bankruptcy law. After five years of practice as an associate, Judge Van Eck continued his legal career at the law firm of Van Eck & Van Eck, P.C., which he co-founded with his wife, Melissa L. Van Eck, Esquire. In 2011, Judge Van Eck became a shareholder with the law firm of Mette, Evans & Woodside, where he served as chair of the Bankruptcy and Corporate Restructuring practice group for 6 years. In total, Judge Van Eck practiced law for 18 years in Harrisburg, Pennsylvania before his appointment as a United States Bankruptcy Judge for the Middle District of Pennsylvania on April 6, 2017. Judge Van Eck was a certified mediator in the United States District Court for the Middle District of Pennsylvania. He has also served on several Pennsylvania Bar Association committees,

including the Federal Practice Committee responsible for commenting on the proposed amendments to the Federal Rules of Appellate, Bankruptcy, Civil, and Criminal Procedure in 2015 and in 2016 and the Business Law Section Task Force regarding the enactment of the Uniform Voidable Transactions Act, formerly known as the Uniform Fraudulent Transfer Act.

Kara K. Gendron, Esq.

Ms. Gendron is a partner and shareholder in Mott & Gendron Law, which is the only mother and daughter lawyer team who are both American Board Certified Consumer Bankruptcy Attorneys. Ms. Gendron is a current Director of the Middle District Bankruptcy Bar Association and is also a board member of the Pennsylvania Bar Association Review and Certifying Board. She is a bankruptcy court certified mediator and taught bankruptcy law for several years at the Widener School of Law. Ms. Gendron has been practicing bankruptcy law for over 18 years. She lives in Central Pennsylvania with her husband, four children, and assorted pets, including dogs, goats, and chickens. In her spare time she enjoys kayaking, gardening, and traveling. Ms. Gendron is a frequent presenter at bankruptcy law seminars for PBI and the Middle District Bankruptcy Bar Association.

Ann E. Swartz, Esq.

Ms. Swartz is the Managing Bankruptcy Attorney and a shareholder with the firm of McCabe, Weisberg & Conway, P.C. in Philadelphia. She received her Bachelor of Arts degree with *cum laude* honors in 1988 from Boston University, majoring in International Relations with a minor in Business Administration. Thereafter, Ms. Swartz obtained her Juris Doctorate in 1991 from Northeastern University in Boston, MA. Ms. Swartz practiced for a number of years in Massachusetts and Rhode Island before relocating to Pennsylvania in 2005. Throughout her career, she has concentrated her practice on creditors' rights, including foreclosure, evictions, commercial loan workouts and state court receiverships with a primary focus on bankruptcy matters. Ms. Swartz has been invited to speak on a number of panels concerning creditors' rights and bankruptcy issues including prior Pennsylvania Bar Institute forums and Middle District Bankruptcy Bar annual conferences as well as various other continuing education panels. Ms. Swartz is a former President and current member of the Middle District Bankruptcy Bar Association. Ms. Swartz is currently admitted to practice in Pennsylvania and in the United States District Court of Pennsylvania in the Eastern, Middle and Western divisions.

Melissa L. Van Eck, Esq.

Mrs. Van Eck is an attorney with the Pennsylvania Office of the Attorney General. She received her Bachelor of Science degree, *cum laude*, in Political Science from Shepherd College in 1997 and her Juris Doctor from Widener University School of Law in 2000. Mrs. Van Eck represents the Commonwealth in bankruptcy proceedings, as well as, state court collection matters. A leader in and out of her profession, Mrs. Van Eck is a Director for the Middle District Bankruptcy Bar ("MDBBA"). She also serves as President of her Homeowner's Association and is a member of the Central Dauphin School District Curriculum Committee.

James C. Vandermark, Esq.

Mr. Vandermark is an Associate with White and Williams LLP in Philadelphia and works in the firm's Bankruptcy and Financial Restructuring Group. His practice primarily

involves representation of clients involved in commercial and consumer bankruptcies, corporate restructuring, complex commercial litigation, and out-of-court workouts. Prior to joining White and Williams LLP, he was a Deputy City Solicitor with the City of Philadelphia Law Department and represented the City's interests in bankruptcy cases as well as tax fraud and tax dispute litigation. Mr. Vandermark is a graduate of the University of Pittsburgh with a Bachelor of Science in Psychology and a Bachelor of Arts in Economics and Political Science. In addition, he received a J.D. and LL.M. in Taxation from Temple University.

Jeremiah J. Vandermark, Esq.

Mr. Vandermark is an associate at Saul Ewing Arnstein & Lehr LLP, in Philadelphia, and represents businesses and municipalities in matters involving bankruptcy, restructuring, litigation and commercial law. His bankruptcy experience includes Chapter 11 proceedings, 363 sales, plans of reorganization, claim disputes and landlord-tenant matters. He also handles negotiations with creditors' committees and DIP lenders, including restructuring issues and out-of-court workouts. His commercial law experience includes litigation involving contracts, fraud, and regulatory and tax compliance. Mr. Vandermark earned his J.D. from the University of Pittsburgh School of Law.

JUDICIAL FACULTY

Hon. Ashely M. Chan

Judge Chan sits as a bankruptcy judge for the Eastern District of Pennsylvania. Prior to taking the bench, Judge Chan was a shareholder at Hanglely Aronchick Segal Pudlin & Schiller and concentrated her practice in the areas of bankruptcy and corporate restructuring. She is a 1996 graduate of Rutgers School of Law – Camden, where she received Tax Honors with Distinction and received the Rutgers Pro Bono Publico Award. From 1996 to 1997, Judge Chan served as law clerk for the Honorable Gloria M. Burns of the United States Bankruptcy Court for the District of New Jersey. Before joining HASPS, she was an associate at Morgan, Lewis & Bockius LLP in the business and finance section where she focused on bankruptcy, corporate restructuring, and corporate finance. She has received numerous recognitions, including being selected as a Leader in Bankruptcy/Restructuring by *Chambers USA*, a Best Lawyer in America in Bankruptcy and Creditor-Debtor Rights and a Pennsylvania Lawyer on the Fast Track by *The Legal Intelligencer* and *Pennsylvania Law Weekly*. She also served as Chair of the Eastern District of Pennsylvania Bankruptcy Conference and President-Elect and Board Member of the Homeless Advocacy Project.

Hon. Judith K. Fitzgerald(Ret.)

Judge Fitzgerald became a shareholder at Tucker Arensberg, P.C. after her retirement from the bench. She concentrates her practice in commercial law and has served as an expert witness, consultant, mediator and arbitrator. Judge Fitzgerald was appointed to the Bankruptcy Court for the Western District of Pennsylvania on October 30, 1987, after serving nearly 12 years as an Assistant United States Attorney. She sat by designation in the Bankruptcy Courts for the District of Delaware, the Eastern District of Pennsylvania and the District of the U.S. Virgin Islands. Judge Fitzgerald teaches Bankruptcy and Advanced Bankruptcy Law as Professor in Practice at the University of Pittsburgh School of Law. She taught Contracts, Bankruptcy and Commercial Transactions as a tenured

professor at Indiana Tech Law School. She is active in several professional organizations and is an elected member of The American Law Institute, a Fellow of the American College of Bankruptcy, and a member of Bankruptcy Section Executive Council of the Commercial Law League of America. She is a past President of the National Conference of Bankruptcy Judges. She held a seat on the board of the American Bankruptcy Institute (ABI). She co-edits the treatise, *Rutters National Bankruptcy Practice Guide*, and publishes and lectures on bankruptcy, evidence and litigation topics. The Bankruptcy Inn of Court she organized in Western Pennsylvania has been renamed in her honor. Judge Fitzgerald is actively involved in numerous educational opportunities for judges and practitioners in the insolvency arena. She designed and implemented the Next Generation Program for the NCBJ. For the ABI, she was instrumental in creating a law school writing competition and in establishing the Mid-Atlantic Region Annual Conference. She has served as co-chair of the Mass Tort Committee and advisor to the ABI Caribbean Conference. Judge Fitzgerald held the position of non-voting representative to the Third Circuit Council and sat on its Bankruptcy and Magistrate Judges Committee. She was a member of the Bankruptcy Judges Advisory Committee of the Administrative Office of the United States Courts, which she chaired for two years, and the Education Committee for the Third Circuit. She has participated in several advisory groups and worked on projects concerning automation and technology policy formulation with the Administrative Office of the United States Courts. Judge Fitzgerald is has been recognized nationally for her service to the bench and bar.

Hon. Michael B. Kaplan

Judge Kaplan was appointed as a bankruptcy judge on October 3, 2006, for the District of New Jersey. Prior to taking the bench, Judge Kaplan served as a Standing Chapter 13 Bankruptcy Trustee, as well as a member of the Chapter 7 panel of bankruptcy trustees, where he received case appointments as both a Chapter 11 and Chapter 12 trustee. His private practice included the representation of institutional lenders consumer debtors (under both Chapters 7 & 13), business debtors and individuals undergoing reorganization pursuant to Chapter 11. Judge Kaplan received his A.B. degree from Georgetown University (1984) and his J.D. Degree from Fordham University School of Law (1987). He is licensed to practice law in New Jersey, New York and Connecticut, and is admitted to practice before the U.S. Supreme Court, Third Circuit Court of Appeals, U.S. Court of International Trade and various federal district courts. Over the past thirty years, Judge Kaplan has spoken to numerous bar associations and business organizations, and authored several articles relating to bankruptcy issues. Judge Kaplan is a co-author of West's *Consumer Bankruptcy Manual* and *Consumer Bankruptcy Handbook*. Additionally, he serves on the Editorial Board and as Business Manager for the *American Bankruptcy Law Journal* and teaches as an adjunct professor at Rutgers University School of Law. Judge Kaplan has been the recipient of the Conrad B. Duberstein Memorial Award given by the New York Institute of Credit, the Judicial Service Award from the Association of Insolvency and Restructuring Advisors, the National Association of Chapter 13 Trustees' 2006 Distinguished Service Award and New Jersey State Bar Association's 1999 Legislative Recognition Award. Judge Kaplan has been appointed by the Director of Administrative Office of the Courts to a term as the Third Circuit representative to the Bankruptcy Judges Advisory Group, in addition to appointments as the Bankruptcy Judge representative on both the Human Resources Advisory Council and Budget & Finance Advisory Council to the AO. He is a member of the National Conference of Bankruptcy Judges, Turnaround Management Association, American Bankruptcy Institute and the Commercial Law League

of America. Prior to taking the bench, Judge Kaplan served as Mayor and Councilman for the Borough of Norwood, NJ, and as a member of the Norwood Planning Board.

Hon. Robert N. Opel

Judge Opel was appointed as a Bankruptcy Judge in the Middle District of Pennsylvania on September 28, 2006. He is a member of the National Conference of Bankruptcy Judges. He has served as the Third Circuit Representative to the NCBJ since October 2016. Judge Opel received his Juris Doctor from Temple Law School and was admitted to the practice of law in the Commonwealth of Pennsylvania in 1978. In his private practice, he concentrated on bankruptcy matters. Judge Opel served as a Chapter 7 Bankruptcy Trustee in the Middle District of Pennsylvania from 1998 to 2006 and was also a certified Bankruptcy Mediator beginning in 1998. Judge Opel is a past Vice President of the Middle District Bankruptcy Bar Association and a member and past President of the Luzerne County Bar Association. The Judge is a former member of the National Association of Bankruptcy Trustees and the Pennsylvania Bar Association.

Hon. Laurie S. Silverstein

Judge Silverstein was sworn in as a bankruptcy judge for the District of Delaware on January 7, 2015. She is a member of the Committee on the Budget of the Judicial Conference of the United States. Judge Silverstein is also a Fellow of the American College of Bankruptcy and the American Bar Foundation. She serves on the Board of Directors of the Delaware Bar Foundation and the Executive Committee of The Delaware Bankruptcy American Inn of Court. She is also a member of the Legislative Committee of the National Conference of Bankruptcy Judges. Prior to joining the bench, Judge Silverstein was a partner at Potter Anderson & Corroon LLP in Wilmington, Delaware, where she led the firm's bankruptcy and corporate restructuring practice group. She received her law degree, with honors, in 1985 from The National Law Center of The George Washington University, and her Bachelor of Science, *cum laude*, in 1982 from the University of Delaware.

FACULTY

Andrew T. Archer, Esq.

Mr. Archer is a partner at Brenner Spiller & Archer, LLP located in West Collingswood, New Jersey. Mr. Archer focuses primarily on representing debtors in Chapter 13 and Chapter 7 personal bankruptcy cases in the State of New Jersey. Mr. Archer is a member of the National Association of Consumer Bankruptcy Attorneys, the Camden County Bar Association and the Burlington County Bar Association.

Joseph N. Argentina, Jr., Esq.

Mr. Argentina is a Senior Attorney in the Corporate Restructuring Practice Group at Drinker Biddle & Reath LLP. He joined the firm in 2009 and is a resident in the Wilmington, Delaware, and Philadelphia, Pennsylvania offices. Mr. Argentina's practice focuses on both litigation and transactional work, including the representation of secured and unsecured creditors, landlords, creditor committees and debtors in bankruptcy reorganizations and liquidations. He co-authors a monthly bankruptcy article in *The Legal Intelligencer*. A member of the American Bankruptcy Institute, Mr. Argentina is a member of the state bars of Delaware and New Jersey and the Commonwealth of Pennsylvania. He

earned his J.D. from Temple University Beasley School of Law, where he graduated *cum laude* and served on the *Temple Law Review*. He received his B.A. from Rutgers University.

Derek J. Baker, Esq.

Mr. Baker is a partner in Reed Smith LLP's Financial Industry Group, resident in the Philadelphia and Princeton offices, practicing in the area of Commercial Restructuring & Bankruptcy. He represents major constituencies (including debtors, secure creditors, creditor committees, landlords, equipment lessors and indenture trustees) in workouts, restructurings, foreclosures and bankruptcies throughout the country. Mr. Baker has substantial first chair trial experience in state and federal courts (including bankruptcy courts) addressing varying issues ranging from enforcement of creditor remedies to contested confirmation hearings on plans of reorganization. His experience also includes the transfer and sale of distressed loan and portfolios and other "non-traditional" exit strategies. Mr. Baker has substantial experience in documenting front-end and forbearance credit transactions, as well as negotiating out of court liquidations and counseling creditors on the exercise of state court remedies, including issues relating to Article 9 of the Uniform Commercial Code.

David M. Banker, Esq.

Mr. Banker is a partner in Montgomery McCracken's Business Department, in New York, and is a member of the firm's Bankruptcy & Financial Restructuring practice group. He focuses his practice on creditors' rights in the context of complex bankruptcies, including providing counsel to unsecured creditors' committees, institutional trade creditors, plan trustees, investment funds, secured lenders, and lessors. He has represented the unsecured creditors' committees in Orchids Paper, CST Industries, Willowood USA Holdings, Centerstone Linen, Prestige Industries, Noranda Aluminum, Borders Group, SP Newsprint, Gourmet Express, Chef Solutions, Advanced Marketing Services, Koen Book Distributors, Solaris Industries, and Xtera Communications. Mr. Banker has extensive experience defending preference and fraudulent conveyance actions in numerous jurisdictions throughout the country. He is a certified mediator included on the register of mediators for the Southern District of New York and Delaware Bankruptcy Courts. Most recently, he has served on the panels of mediators for the Loehmann's, Furniture Brands, GT Advanced Technologies, Vivaro, and WireflyMobile bankruptcy cases. Mr. Banker advises clients through all steps of the bankruptcy process, including pre-bankruptcy planning, negotiating the sale of claims, and defending claim objections. He also works extensively with lessors in negotiations over the terms of the assumption and cure of leases, adequate protection orders, and claims related to lease rejection. Prior to joining Montgomery McCracken, Mr. Banker was an attorney at a large international law firm.

Patrick J. Best, Esq.

Mr. Best is a partner at ARM Lawyers in Stroudsburg and currently handles the firm's bankruptcy and tax matters in Pennsylvania, New Jersey, New York, and Maryland. He handles bankruptcies for individuals and businesses under Chapters 7, 11 and 13 of the Bankruptcy Code and also represents taxpayers in tax matters before the IRS. Mr. Best is a past member of the Board of Directors for the Middle District Bankruptcy Bar Association. In 2019, Attorney Best earned a Certificate in Reasonable Attorney Fees from the National Association of Legal Fee Analysis (NALFA). Attorney Best now serves as a fellow with NALFA and serves as an expert in attorney's fees and legal billing in a variety of cases in

both state and federal courts including bankruptcy court. He is a graduate of the University of Pittsburgh School of Law and the Rochester Institute of Technology.

David L. Buchbinder, Esq.

Mr. Buchbinder is a trial attorney with the Office of the United States Trustee in Wilmington, Delaware. He is a member of the Pennsylvania, New Jersey and California Bars. Prior to 1995, Mr. Buchbinder practiced bankruptcy law in San Diego, California, serving as a Chapter 7 Trustee and a Chapter 11 Trustee and Examiner. He has lectured extensively on Bankruptcy and Consumer Law subjects in Pennsylvania, New Jersey, Delaware and California. Mr. Buchbinder's textbook, *Basic Bankruptcy for Paralegals*, published by Aspen Publishing Company is currently in its Tenth Edition. He has served on the editorial board of "The Bankruptcy Strategist". He is a member of the Eastern District Bankruptcy Conference and the Delaware Bankruptcy Inn of Court. In March 2004, Mr. Buchbinder received an Equal Justice Medal from Legal Services of New Jersey and the New Jersey State Bar for his pro bono contributions in providing training to Legal Services attorneys. He earned his J.D. from the Notre Dame Law School and an LL.M. from New York University School of Law. When not practicing law, Mr. Buchbinder is a military historian, specializing in the European Theater of Operations, the Napoleonic and American Civil War periods.

Steven M. Carr, Esq.

Mr. Carr is the senior partner in the York law firm of Ream, Carr, Markey, Woloshin & Hunter LLP and has a diverse civil practice, including extensive bankruptcy experience. He serves as a Panel Trustee for the United States Bankruptcy Court in the Middle District of Pennsylvania and provides representation to both debtors and creditors in collection and bankruptcy matters. Mr. Carr is a member of the York County Bar Association and Pennsylvania Bar Association as well as the National Association of Bankruptcy Trustees. He received his B.A. from LaSalle College in 1978 and received his J.D. in 1981 from the Dickinson School of Law.

Michael A. Cataldo, Esq.

Mr. Cataldo is a partner in the Philadelphia firm of Cibik & Cataldo, PC. He has been with the firm since 1985 and became a partner in 1993. He is a Senior Certified Bankruptcy Attorney and has been certified by the American Bankruptcy Institute in consumer bankruptcy matters for 27 years. Mr. Cataldo graduated with a B.S. from Villanova University in 1984 and received his J.D. from Temple Law School in 1987. He has been an active presenter at seminars for the Pennsylvania Bar Institute and Eastern District of Pennsylvania Bankruptcy Conference.

Robert E. Chernicoff, Esq.

Mr. Chernicoff is a member and managing director of Cunningham & Chernicoff, P.C., in Harrisburg, where he has practiced since 1981. Mr. Chernicoff graduated from the Washington University School of Law in St. Louis, Missouri with honors, where he was elected as a member of the Order of the Coif and was the associate managing editor of the *Urban Law Journal*. He was an assistant attorney general for the Commonwealth of Pennsylvania from 1976 to 1981, and assistant chief counsel for the Department of Labor and Industry, Commonwealth of Pennsylvania, in 1981. A member of the Dauphin County, Pennsylvania and American Bar Associations and the American Bankruptcy Institute, Mr.

Chernicoff lectures on business bankruptcy and reorganization law and the formation and counseling of small businesses. He has been involved in Chapter 11 cases representing debtors, creditors and committees for many years. Mr. Chernicoff concentrates his practice in the areas of business and consumer bankruptcies (representing both creditors and debtors) and general business law. He was selected to The Best Lawyers in America for several years in the field of bankruptcy law, as well as being selected for the Pennsylvania Super Lawyers. Mr. Chernicoff is currently the chair of the Dauphin County Bar Association, Bankruptcy Section, and a member of the Middle District Bankruptcy Court Liaison Committee and Rules Committee.

Clayton W. Davidson, Esq.

Mr. Davidson is a partner at McNees Wallace & Nurick LLC and chairs the firm's financial services group in Harrisburg. He is a member of the Pennsylvania and Dauphin County bar associations, as well as the American Bankruptcy Institute and the Commercial Law League of America. Mr. Davidson is admitted to practice before all Pennsylvania courts and the United States District and Bankruptcy courts for the Western, Eastern and Middle Districts of Pennsylvania, as well as the United States Court of Appeals for the Third Circuit. He received a B.S. in Finance from The Pennsylvania State University in 1993 and his J.D. from The Dickinson School of Law in 1996. Mr. Davidson focuses primarily in representing creditors in a broad range of litigation matters involving bankruptcy and commercial law throughout the United States.

Brent C. Diefenderfer, Esq.

Mr. Diefenderfer practices a client-first approach in the practice of law. He identifies multiple courses of action; gives straightforward advice and diligently works to achieve results. Mr. Diefenderfer is detailed oriented and ensures his clients' matters are handled correctly, efficiently and in a cost-effective manner. His diverse clientele includes individuals, businesses and government entities in implementing a debt reduction strategy that is appropriate to their unique situation - including Bankruptcy under Chapters 7, 13 or 11 of the Bankruptcy Code, creditor negotiation, mortgage loan modification or real estate "short sale." Mr. Diefenderfer's bankruptcy practice has saved dozens of clients' homes and cars from foreclosure and repossession, has resolved burdensome tax obligations and has given scores of clients a "fresh start" and debt-free future. He is certified as a Consumer Bankruptcy Specialist by the American Board of Certification, and is the second attorney in York and Adams Counties to hold this designation. Prior to joining CGA Law Firm, Mr. Diefenderfer served as an active-duty Army Officer and Judge Advocate (JAG) Attorney. He brings to his civilian practice an invaluable and well-rounded experience ranging from advising senior military officers on complex legal issues to litigating contested jury trials. Mr. Diefenderfer held the rank of Captain and served as a Trial Defense Counsel at Fort Bragg, North Carolina where he defended soldiers of the 82nd Airborne Division and U.S. Army Special Forces Command in over 30 jury and bench trials, many which resulted in acquittals for his clients. In 2005, Mr. Diefenderfer deployed to Iraq for a year as part of the elite 101st Airborne Division "Screaming Eagles" and acted as lead counsel for all legal claims brought by Iraqi citizens against the U.S. Government occurring in a 6,000 square mile combat zone. Later, Mr. Diefenderfer served as general counsel for his Commanding General and installation's administrative agencies by advising on fiscal, employment and administrative law related matters.

Robert Ian Evans, Esq.

Mr. Evans is an Assistant City Solicitor in the City of Philadelphia Law Department, where he practices in the Arbitration Division of the Tort Litigation Unit. He currently serves as co-chair of the LGBT Rights Committee of the Philadelphia Bar Association and is a member of the Philadelphia and Pennsylvania Bar Associations. Before practicing as an Assistant City Solicitor, Mr. Evans served as law clerk to the Honorable M. Teresa Sarmina, during which time Judge Sarmina presided over the Salvation Army building collapse trial *Harmon et al. v. Basciano et al.*, which became the longest civil trial in Pennsylvania state court history. He earned his B.A. and his J.D. from Temple University.

Lawrence G. Frank, Esq.

Mr. Frank is the principal in the Law Office of Lawrence G. Frank in Dillsburg. He serves on the private panel of trustees as a Chapter 7 and Chapter 12 trustee. He is a member of the Dauphin County and Pennsylvania Bar Associations. He is a frequent lecturer on bankruptcy topics including to the Pennsylvania Magisterial District Judges. He earned his B.A. from the University of Pennsylvania and J.D. from the Dickinson School of Law.

Howard Gershman, Esq.

Mr. Gershman is the principal of Gershman Law Offices, PC, in Jenkintown, PA. He is a graduate of LaSalle University and Temple University School of Law. He has lectured on UCC Article 9 as well as bankruptcy and other creditor rights matters. He is a member of the Eastern, Middle, and Western Districts of Pennsylvania Courts, as well as the American Bankruptcy Institute and its Uniform Commercial Code and Consumer Bankruptcy Committees, for which he has contributed work for the *ABI Journal* and committee newsletters. Mr. Gershman has participated as a panelist on number continuing legal education seminars including those for the Pennsylvania Bar Institute, Eastern District Bankruptcy Conference, the Middle District (PA) Bankruptcy Bar Association, and Montgomery Bar Association.

Matthew A. Hamermesh, Esq.

Mr. Hamermesh is a shareholder at Hangley Aronchick Segal Pudlin & Schiller, P.C. and a leader in the firm's Appellate and Bankruptcy practices. His practice covers a wide range of litigation and bankruptcy work. In his bankruptcy practice, he has represented debtors, creditors, committees, and receivers in bankruptcy court proceedings, litigation, and various business transactions. He has been recognized repeatedly by *Pennsylvania Super Lawyers* magazine as both a Rising Star and a Super Lawyer. Mr. Hamermesh is also active in pro bono work, representing clients in a wide variety of cases, including death penalty defense, prisoners' civil rights, bankruptcy, and uninsured tort defense. Mr. Hamermesh is an active member of the Eastern District of Pennsylvania Bankruptcy Conference. He recently chaired a subcommittee of the Eastern District of Pennsylvania Bankruptcy Court's Local Rules Revision Committee. Mr. Hamermesh received a BS in mathematics from Yale University. He graduated from the University of Michigan Law School *magna cum laude*, where he served as an articles editor for the *Michigan Law Review* and was a member of the Order of the Coif. After law school, he served as a law clerk for the Honorable Edward R. Becker, Chief Judge of the United States Court of Appeals for the Third Circuit.

David J. Harris, Esq.

Mr. Harris is a practitioner who maintains an office in Wilkes-Barre, Pennsylvania. He practices in both Pennsylvania and Florida in the areas of bankruptcy, tax, estate, and business and property law and engages in litigation involving those practice areas. Mr. Harris received his undergraduate degree in History from the Pennsylvania State University and a law degree with honors from the University of Miami where he was the recipient of American Jurisprudence awards in Trusts and Estates and Administrative Law. He also received a Master of Laws degree in Taxation from the New York University School of Law. Mr. Harris is a member of the Bars of the States of Pennsylvania and Florida, and is admitted to practice before the United States Supreme Court, United States Court of Appeals for the Third Circuit, the United States District Court for the Middle District of Pennsylvania and the United States Tax Court. He has served as a mediator in bankruptcy and estate matters.

Gary J. Imblum, Esq.

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Chapter One

Top Consumer Cases: Short Summaries

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Top Consumer Bankruptcy Cases Eastern District

Supreme Court

Taggart v. Lorenson, et. al., ___ U.S. ____ (2019)(per Bryer, J.)

At the conclusion of a bankruptcy proceeding, a bankruptcy court typically enters a discharge order which bars creditors from attempting to collect any debt covered by the order. The question presented before the Supreme Court concerned the criteria for determining when a court may hold a creditor in civil contempt for attempting to collect a debt that a discharge order has immunized from collection.

The Bankruptcy Court, in holding the creditors in civil contempt, applied a standard that it described as akin to “strict liability” based on the standard’s expansive scope. *In re Taggart*, 522 B. R. 627, 632 (Bankr. Or. 2014). It held that civil contempt sanctions are permissible, irrespective of the creditor’s beliefs, so long as the creditor was “aware of the discharge” order and “intended the actions which violate[d]” it. *Ibid.* (quoting *In re Hardy*, 97 F. 3d 1384, 1390 (11th Cir., 1996)). The Court of Appeals for the Ninth Circuit, however, disagreed with that standard. Applying a subjective standard instead, it concluded that a court cannot hold a creditor in civil contempt if the creditor has a “good faith belief” that the discharge order “does not apply to the creditor’s claim.” *In re Taggart*, 888 F. 3d 438, 444 (2018). That is so, the Court of Appeals held, “even if the creditor’s belief is unreasonable.” *Ibid.*

In a unanimous decision, the Supreme Court concluded that neither standard was appropriate. Rather, it ruled that a court may hold a creditor in civil contempt for violating a discharge order if there is *no fair ground of doubt* as to whether the order barred the creditor’s conduct. In other words, civil contempt may be appropriate if there is no objectively reasonable basis for concluding that the creditor’s conduct might be lawful. The court vacated the judgment and remanded the case for further proceedings.

Automatic Stay

In re Dunn, 589 B.R. 253 (E.D. Pa. 2018)(per Leeson, J.)

The Bankruptcy Court granted the Debtor’s motion for sanctions for violating the automatic stay, because Toyota repossessed his vehicle prior to the expiration of time for him to reaffirm the debt. The District Court held that the Bankruptcy Court correctly concluded that § 521(a)(2)(A) and (B) requires four actions: (1) a debtor must timely file the statement of intention, (2) a debtor must declare that he intends to retain or surrender the collateral, (3) a debtor must, if he chooses to retain the collateral, indicate his intent to either redeem the collateral or to reaffirm the debt, and (4) a debtor must timely perform the action indicated in his statement of intention. While the automatic stay may terminate automatically 30 days after the meeting of creditors if no reaffirmation agreement is signed and performed, the District Court agreed with the Bankruptcy Court that Toyota wrongfully repossessed the Land Rover only sixteen days into the thirty days allotted to the Debtor to perform his stated intention, and affirmed Bankruptcy Court's order that the

lender violated the automatic stay.

In re Donaghy, No. 18-16459, Bankr. E.D. Pa. 2019) (per Frank, J.)

HSBC obtained a prepetition consent judgment and then sought relief from the automatic stay to proceed with foreclosure when Debtor's amended plan failed to provide for it. The Debtor's sole defense to the motion was the creditor's standing to seek such relief.

There are five (5) ways to treat an allowed secured claim in a chapter 13 plan: (1) surrender; (2) provide that the creditor retains its lien and receives payments during plan that has a present value not less than allowed amount of secured claim (payoff claim in the bankruptcy); (3) curing default and complete contract payments; (4) not provide for a secured claim. See In re Stuart, 403, 111, 123 (Bankr. E.D. Pa. 2009); and (5) convincing the creditor to accept some other treatment.

HSBC filed a secured claim with an arrearage of \$439,918.00. The Debtor's Amended Plan failed to "provide for" the claim. The Debtor then objected to the claim arguing that HSBC lacked standing. The Debtor argued that the existence of the consent judgment did not conclusively establish standing. The Court disagreed holding there is no better proof of a party's right to enforce a mortgage on Pennsylvania real property than the existence of a Pennsylvania state court judgment in its favor, which HSBC had obtained. A consent judgment is a fully effective court judgment that binds the parties and the doctrine of *res judicata* applies. A final judgment on the merits precludes the parties from relitigating defenses that could have been raised in the prior action.

The Court ruled that HSBC was entitled to relief from the automatic stay for two reasons; First, the Debtor had not made post-petition monthly payments under the mortgage note and did not propose any other means of adequate protection of HSBC's interest in the secured property. Second, the Debtor's Amended Plan did not provide for the subject debt. If the holder of a secured claim is not provided for in a chapter 13 plan, the creditor is entitled to relief from the automatic stay.

In re Schaffer, No. 18-18133 (Bankr.E.D. Pa. 2019)(per Chan, J.)

An unsecured creditor may be entitled to relief from the automatic stay "for cause" under §362(d)(1) where the court determines that a debtor filed the bankruptcy in bad faith. When an unsecured creditor seeks to lift the automatic stay in order to continue litigation in another forum, courts engage in a balancing test allowing modification of the stay where no great prejudice to either the debtor or the estate would result and where hardship to the plaintiff caused by the continuance of the stay outweighs the hardship to the debtor caused by the stay modification.

To determine whether the case has been filed in bad faith court must examine the totality of the circumstances. Two of the most important factors to consider include (1) whether the petition serves a valid bankruptcy purpose and (2) whether the petition was merely filed to obtain a tactical litigation advantage. Other factors include (1) whether the debtor has few or no unsecured creditors; (2) whether the debtor has prior bankruptcies; (3) improper prepetition conduct; (4) the petition allows the debtor to evade court orders; (5) few debts to non-moving creditors; (6) the petition was filed on eve of foreclosure; (7) the foreclosed property is the sole or major asset of the debtor, (8) the Debtor has no ongoing

business; (9) no possibility of reorganization; (10) the debtor's income is insufficient to operate; (11) lack of pressure from nonmoving parties; (12) reorganization involves a two party dispute; the debtor filed solely to create the automatic stay.

In this Chapter 11 case which was converted from Chapter 13, almost all the factors were triggered. The debtor listed only two unsecured creditors in his schedules and filed the case to evade writ of execution. Another major factor not enumerated above was what the debtor did after the case was filed. He spent a \$100,000 inheritance after the Chapter 13 Trustee warned him that those funds were estate property to be used to pay creditors only.

The court granted the motion for relief.

Trokie v. U.S. Bank Tr. N.A. (In re Trokie), 590 B.R. 663 (Bankr.M.D. Pa. 2018 (per Opel, J.)

Debtor filed a three-count adversary action against a creditor alleging, *inter alia*, that the creditor's inaccurate motion for relief was in fact a stay violation. The Bankruptcy Court found the Debtor's argument illogical. Filing a motion for relief is a procedural necessity to not violate the automatic stay. Therefore, filing a motion for relief cannot be a violation of the automatic stay even if the information in the motion is inaccurate. The Court dismissed that count.

Valez v. EX Rent A Car, Inc., (In re Valez), 18-ap-00138-RNO (Bankr.M.D. Pa. 2019) (per Opel, J.)

The Debtor filed an adversary action alleging that his car lessor violated the automatic by repossessing his leased 2012 Chrysler 200LX too early in a case. When read in conjunction, §§ 362(h)(1) and 521(a)(2) terminate the stay with respect to personal property of the estate, which is subject to an unexpired lease, if the debtor fails (1) to file, within thirty days after the date of the filing of the petition, a statement of intention with respect to such personal property indicating that the debtor will be surrendering or retaining such personal property; and (2) to perform debtor's intention with respect to such property within 30 days after the first date set for the meeting of creditors. See *In re Dunn*, 589 B.R. 253, 258 (E.D. Pa. 2018) (citing *In re Miller*, 443 B.R. 54, 58 (Bankr. D. Del. 2011) (holding that "section 362(h) provides that the stay will be terminated, and the collateral will no longer be property of the estate if the debtor fails to file and to perform a statement of intention to surrender, to redeem, to reaffirm or, in the case of leased property, to assume the unexpired lease")).

In this case, the Debtor filed his bankruptcy petition on September 14, 2018. The automatic stay took effect, including as to Debtor's personal property (i.e., the Vehicle), at the moment Debtor's bankruptcy petition was filed. 11 U.S.C. § 362(a). The Debtor's bankruptcy petition included a statement of intention which provided that Debtor intended to retain the Vehicle and would continue making payments to the lessor without reaffirming. The statement of intention was clearly filed within the thirty-day time-period required by §§ 362(h)(1)(A) and 521(a)(2)(A). Therefore, the stay did not terminate thirty days post-petition, and Debtor was granted the benefits of the stay as to his personal property, including the property covered by the Agreement, until, at least, thirty days following the first date set for the meeting of creditors.

The creditor did not wait until 30 days after the meeting of creditors to exercise its dominion over the car. The creditor debited the Debtor's bank account, remotely disabled the vehicle and repossessed the car before the automatic stay expired. Therefore, the court held that the creditor violated the automatic stay by disabling and then repossessing the vehicle.

Conversion to Chapter 13

In re Campbell, 18-00773(Bankr.M.D. Pa. 2019)(per Opel, J.)

The Bankruptcy Court denied the Chapter 7 Debtor's motion to convert to Chapter 13 after the Chapter 7 Trustee objected. In *Marrama v. Citizens Bank of Massachusetts*, the Supreme Court held that a debtor does NOT have an absolute right to convert from Chapter 7 to 13. Courts have considered the following factors in evaluating a motion to convert from Chapter 7 to Chapter 13:(i) whether the debtor is seeking to convert to chapter 13 in good faith (including a review of facts such as the timing of the motion to convert; the debtor's motive in filing the motion; and whether the debtor has been forthcoming with the bankruptcy court and creditors); (ii) whether the debtor can propose a confirmable chapter 13 plan; (iii) the impact on the debtor of denying conversion weighed against the prejudice to creditors caused by allowing conversion; (iv) the effect of conversion on the efficient administration of the bankruptcy estate; and (v) whether conversion would further an abuse of the bankruptcy process. In this case, the Debtors were not able to prove that their financial circumstances had improved to fund a confirmable plan. **Practice pointer:** When moving to convert to Chapter 13 always prepare a proposed Chapter 13 plan.

Dischargeability Actions

Lehigh Valley Hospital v Dietrich, (In re: Dietrich), Adv. No. 17-259 (Bankr. E.D. Pa., 2018)(per Fehling, J.)

According to the Bankruptcy Court, "I know nothing" may work for *Hogan's Heroes'* Sgt. Schultz, but not as a defense to a dischargeability complaint.

The Debtor chose to have brain surgery at a hospital he knew was not participating in his Blue Cross coverage. Thus, his insurer would send the money to him, and he would pay the hospital. Only he didn't—three times. Each time he endorsed the insurer's check and spent the money, a total of more than \$95,000. The Debtor insisted he did not read, let alone understand, (three) Consent Forms—each assigning the insurance proceeds he would get to the hospital--or Explanation of Benefits he received with each check.

Upon receipt of the funds, each with a detailed Explanation of Benefits, he made clandestine calls from a friend's phone supposedly to determine why he received the money but refused to give the insurer identifying information so that the specific information could be recovered. The Court held that he debt is non-dischargeable under both Sections 523(a)(2)—fraud—and 523(a)(6)—as willful and malicious injury, each of which the hospital successfully proved by a preponderance of evidence.

The Court found that at the time Debtor engaged the hospital he had the requisite intent to defraud the hospital of the insurance funds assigned to it by the Consent Forms—inferring that from, *inter alia*, the debtor having signed consent/assignment of insurance

forms three times, deliberately spending money he knew was to pay the hospital. §523(a)(2)(A).

The Court also found that Debtor's conduct was "willful." The Debtor deliberately spent the money—but also "malicious" in the sense that he acted wrongfully and without just cause or excuse, resulting loss or injury to the hospital. §523(a)(6). The Debtor actually never had any legal interest in the insurance proceeds, having assigned them to the hospital, knowing of no alternative means of paying a bill he knew was owed.

Discovery Sanctions

Finkel, Trustee v. WeVeel, et al., Adv. No. 14-0333 (Bankr. E.D.Pa 2018) **(per Chan, J.)**

The Court, with as much an admonition as opinion, imposed sanctions of \$81,205 in fees and an additional \$1,608.88 in costs upon finding that Defendants unreasonably withheld crucial financial documents and engaged in a pattern of deceit and delay. Boilerplate objections and responses, and noncompliance with litigated orders to compel, providing multiple insufficient responses, denying documents existed or are irrelevant, or are not physically recoverable in a business-like manner, offering 18 boxes of unorganized documents and suggesting your own financial records were less than reliable, all combined to make Defendants' discovery travails perhaps worse than whatever happens at trial. The Court highlighted various discovery violations:

No Monetary Sanctions under Fed.R.C.P 37(b)(2)(C) for a Rule 34 [Producing Documents]

It is the objecting party's burden to show that the records are produced as they are kept in the usual course of business or must organize and label them to correspond to the categories in the [discovery] request. FRCP 34(b)(2)(E)(i). An appropriate sanction, which was directed by the Court, is to compel proper organization.

*Monetary sanctions are **mandatory** under Fed.R.C.P. 37(a)(5)(A) [costs of a required motion to compel] and 37(b)(2)(C)[failure to comply with order to compel discovery]*

To avoid such sanctions the objecting party must establish that the requesting party did not first make a good faith effort to avoid judicial involvement or that the nondisclosure was "substantially justified" or there are "other circumstances" that would mitigate against a financial award. [FRCP 37(a)(5)(A)(ii)and (iii).

There is "substantial justification" in failing to produce only when a *reasonable person would conclude that the parties could differ as to whether disclosure was required*. It is not the objecting party's own determination or even good faith that controls. In this case, where defendant was alleged to be the recipient of a fraudulent transfer of debtor's products and work product, defendant's sales records, QuickBooks records, and organized business records were indisputably relevant, even if, as Defendant claimed, they were unverified and contained errors. Forcing a Trustee's to employ "extraordinary efforts" to get such information justified a meaningful sanction.

Defendants' objections to the particular legal services and costs for which it should be liable

With great detailed analysis of the legal fees and costs sought by the Trustee, Defendants, at their own significant expense objected to almost everything the Trustee requested. It did not go well for Defendants. The Court, in exercising its obligation to

independently assess the reasonableness of the fees and costs sought, found:

- Fees and costs were recoverable for services that would have been necessary anyway
 - the review of the 18 boxes of documents because producing random boxes in such a disorganized manner violates discovery rules. Further, it was through this review that the Trustee discovered material information Defendants claimed did not exist.
- Spending a combined 25.8 hours of time examining 14,000 documents to locate information otherwise promised by Defendants was reasonable.
- Time to prepare and prosecute the Motion for Sanctions, etc., was recoverable and reasonable.
- [Defendants “win” one....Fees (<\$3000) disallowed for some review of financial records]

Sanctions do not automatically end upon ultimate delivery of discovery

Defendants’ own costs are not a “sanction” in itself for which Defendants should be given “credit” - Defendants are responsible for all reasonable expenses incurred as a result of the failure to produce records in violation of a specific court order, even after they were delivered, which includes the fee application and briefing.

Dismissal Motions

In re Trotta, No. 18-11335 (Bankr.E.D. Pa. 2019)(per Frank, J.)

Creditors, the largest secured and unsecured creditors of the Debtor (and the parents of the Debtor’s separated spouse) moved to dismiss Debtor’s Chapter 7 bankruptcy case under 11 U.S.C. §707(b)(3)(a)and (b).

Section 707(b)(3)(a) allows for dismissal of consumer case filed in “bad faith.” The creditors alleged that the Debtor’s bad faith was demonstrated by his erroneous disclosures in his bankruptcy schedules. For example, he failed to disclose ownership of valuable Rolex watches; he claimed two dependents on schedules when he was only required to have one; he scheduled the Creditors’ claim against him as between \$60,000 and \$200,000 when they sued him for \$260,000; and the debtor claimed that the marital home had equity, when it had none. Aside from the Rolex watches, the court quickly concluded that none of the other inaccurate disclosures comes close to establishing bad faith. The creditors were unable to connect the shortfall in the disclosures to an improper purpose indicative of bad faith.

Regarding the Rolex watches the Court noted, a petition may be considered to have been filed in bad faith if it was accompanied by schedules and disclosures that hide valuable assets. Such an attempt to hold back assets for post-bankruptcy use, while seeking relief from debts, is an abuse of the system that justifies dismissal under 11 U.S.C. §707(b). There was conflicting testimony of who was in possession of the watches. The Debtor testified that he lost one and his wife was in possession of the other. His separated wife testified that she saw him wearing both watches. The Court expressed its frustration with the direct contradictory sworn testimony stating ‘It is simply impossible to reconcile the competing testimony and it is not possible to ascribe the differences to failing memory or any other innocent factors. One of them is lying. Indeed, never in my time on the bench

have I observed a more egregious example of a witness testifying under oath to a bald-faced lie.” However, the court could not determine who was the liar.

The Creditors also alleged that the Debtor’s case should be dismissed under §707(b)(3)(b) because of the “totality of the circumstances... of the financial condition of the debtor.” The court applied a seven factor test to consider the issue: Those factor included (1) whether the bankruptcy petition was filed because of sudden illness, calamity, disability or unemployment; (2) whether the debtor's proposed family budget is excessive or unreasonable; (3) whether the debtor enjoys a stable source of future income; (4) whether he is eligible for adjustment of his debts through chapter 13 of the Bankruptcy Code; (5) whether there are state remedies with the potential to ease his financial predicament; (6) the degree of relief obtainable through private negotiations; and (7) whether the debtor's expenses can be reduced significantly without depriving him of adequate food, clothing, shelter and other necessities. The Court noted that while the Debtor lived better than many other debtors, his expenses were reduced from his pre bankruptcy days. While the case did not involve a loss of employment, it does involve marital separation and the imposition of support which effectively reduced the debtor’s disposable income. The creditors were not able to carry their burden and the motion to deny the discharge was denied.

In re Swigert, 18-04351, (Bankr.M.D. Pa. 2019)(per Van Eck, J.)

Is there a *per se* rule prohibiting contemporaneous bankruptcy filings by the same debtor? This Bankruptcy Court answers “no.” In fact, there are no provisions of the Bankruptcy Code which expressly prohibits having multiple cases pending at the same time. In fact, Bankruptcy Rule 1015 suggests that in some situations it is anticipated that the debtor may have two cases open at the same time. Regardless filing a second case while the first case is pending may suggest bad faith and the Court should apply the totality of circumstances test as set forth in In re Myers, 491 F.3d 120 (3rd Cir. 2007) to determine whether the case should be dismissed. Those factors include the nature of the debt; the timing of the petition; how the debt arose; the debtor's motive in filing the petition; how the debtor's actions affected creditors; the debtor's treatment of creditors both before and after the petition was filed; and whether the debtor has been forthcoming with the bankruptcy court and the creditors. Id. The above list is not exclusive and bankruptcy courts have broad discretion to determine good faith, or a lack thereof, based on whether the petitioner has abused the provisions, purpose, or spirit of bankruptcy law. In this case, the Bankruptcy Court easily found bad faith because the Debtors filed their second Chapter 13 case shortly before the sheriff was set to seize their antique cars after the lender obtained the bankruptcy court’s order granting the relief from the automatic stay in the first case.

Dismissal by Debtor

In re Marinari, 596 B.R. 809 (Bankr.E.D. Pa. 2019)(per Chan J.)

The language of the statute seems clear. Section 1307(b) provides, “on request of the debtor at any time, if the case has not been converted under section 706, 1112 or 1208 of this title, the court shall dismiss a case under this chapter.” Yet, the question of whether section 1307(b) gives debtors an absolute right to dismiss a chapter 13 case has deeply divided courts. Judge FitzSimon ruled that a Chapter 13 debtor, in a case that had not been

converted, has an absolute right to dismiss a Chapter 13 case. While the Third Circuit has confirmed that a bankruptcy court has the authority to issue a filing injunction even when approving a debtor's 1307(b) voluntary dismissal, it has abstained from taking a position on the ultimate issue of whether the right to dismissal is absolute. *In re Ross*, 853 F3d 779, 781 (3rd Cir. 2017). In denying the creditor's motion for reconsideration, Judge Chan ruled that Judge FitzSimon's legal conclusion that a Debtor has an absolute right to dismiss a case is supported by a plethora of case law, and since neither the Supreme Court nor the Third Circuit has ruled on the issue, one cannot conclude that she committed a clear legal error.

EXEMPTIONS

In re White, No. 18-131 (Bankr.E.D. Pa. 2019)(per Fehling, J.)

A Chapter 7 Debtor obtained a pre-petition hardship withdrawal in the amount of \$45,000 from her 401(k) account to cure her mortgage arrears. At the time the bankruptcy was filed she had not cashed the check from the 401k administrator. After she filed the case, she endorsed the check and gave it to her attorney who then deposited it into his IOLTA account and then paid the funds to the lender.

The Chapter 7 Trustee filed a complaint against the lender seeking to avoid the transfer of the \$45,000 as an unauthorized post-petition transfer of property of the estate under 11 U.S.C. §549(a). The Debtor defended with two arguments. First, that the money at issue was not property of the estate as of the date of filing, because the check was uncashed, and/or of barred by the "earmarking doctrine" which holds that when a third party makes a loan to a debtor specifically to enable the debtor to satisfy the claim of a designated creditor, the loan proceeds are not considered to be property of the debtor because they have been "earmarked" for payment to the designated creditor. On summary Judgment the Court ruled in favor of the Trustee. For the earmarking doctrine to apply, it requires a new lender. Here there was none so the doctrine was inapplicable. Second, the Debtor did not exempt the \$45,000 *check* in her Amended Schedule C, just the 401k account, and since the money listed in the check had been removed from the 401k account prior to the bankruptcy filing, it was not exempted. The end result is that the Trustee was entitled avoid the transfer and keep the proceeds.

Note: Had the Debtor waited until after the bankruptcy was filed to start the 401k withdrawal process, the entire amount would have been protected.

Fraudulent Transfers

Shearer v. Titus (In re Titus), ___ F.3d ___ (3rd Cir. 2019)(per Ambro, J.)

Wages directly deposited into a joint account with a spouse may be recoverable fraudulent transfers and the non-debtor spouse can be personally liable. While a transfer is not "fraudulent" under the PUFITA if the wages deposited into the account are used to pay for reasonable and necessary household expenses, in cases where funds are used to pay "non-necessities" the court established the following rule: Courts should measure liability when faced with an entireties account like the Tituses' — an account into which deposits consist of both (fraudulent) wages and (non-fraudulent) other sources, and from which cash

is spent on both (permissible) household necessities and (impermissible) other expenditures by presuming that the fraudulent wage deposits were spent on non-necessary expenditures in the same proportion to the overall share of wages in the account as a whole.

Fair Debt Collection Practice Act

Barbato v. Greystone Alliance LLC, No. 18-1042 (3d Cir. 2019) (per Krause, J.)

The Third Circuit ruled that a purchaser of charged off receivables can be deemed a “debt collector” under the Fair Debt Collection Practices Act (“Act”).

Crown Asset Management (“Crown”) was a purchaser of charged-off receivables, which hired an outside collection agency, Turning Point Capital Inc. (“Turning Point”) to collect the debts and it had no direct contact with the Debtor. Turning Point allegedly violated certain provisions of the Act, but Turning Point was dismissed from the litigation leaving only Crown to defend for itself.

The District Court found that Crown was a debt collector but denied summary judgment because the Debtor did not establish that Crown was vicariously liable for Turning Point’s conduct. The District Court certified its decision for interlocutory appeal after the Supreme Court’s *Henson* decision.

The Third Circuit summarily rejected Crown’s first argument that it met the definition of a “creditor” and therefore could not be a “debt collector” under the Act which the Third Court previously addressed in the *Tepper v. Amos* decision. The Third Circuit then addressed whether Crown was a debt collector under the “principal purpose” definition of debt collector. Under the Act there are at least two ways in which an entity could be deemed a “debt collector.” The first is if one “regularly collects a debt”, and the alternative is whether one’s “principal purpose” is that of a debt collector.

The Court noted that *Henson* only addressed the “regularly collects” definition of debt collector not the “principal purpose” definition. The 3rd Circuit found both the broad statutory language and the legislative history supported the District Court’s decision that any entity whose principal purpose is the “collection of any debts” qualifies as a debt collector. The 3rd Circuit reasoned “[a]s long as a business’s *raison d’etre* is obtaining payment on the debt that it acquires, it is a debt collector. Who actually obtains the payment or how they do so is of no moment?” The Third Circuit remanded the case to the District Court on the question of vicarious liability, but in *dicta* provided guidance to the lower court by explaining that the agent does not have to be a debt collector for the principal to be vicariously liable for a FDCPA violation as long as the principal is a debt collector.

Lien Modification

Berger v. Pa Department of Revenue (In re Berger), 2019 WL 1458934 (Bankr.W.D. Pa. 2019)(Taddonio, J.)

Comparing the PA Department of Revenue to the Greek hero *Achilles*, the Bankruptcy Court rejected Revenue’s argument that sovereign immunity bars Chapter 13 debtor’s actions to strip down and strip off tax liens. Lien stripping is the act of removing an

otherwise enforceable or valid lien from a debtor's property when the property is worth less than the total amount owed to secured creditors. The ability to reduce or eliminate liens on over encumbered property represents one of the most powerful tools available to debtors seeking to restructure their financial affairs. The Court held that because the Department of Revenue filed a proof of claim it waived any right to sovereign immunity under 11 U.S.C. § 106(b). Alternatively, the Court found that sovereign immunity was abrogated by Congress pursuant to § 106(a) with respect to the lien-stripping process found in the Bankruptcy Code.

Lien Validity

In re B&M Hospitality, LLC, 584 B.R. 88 (Bankr.E.D. Pa. 2018)(per Chan, J.)

Can a lender have a lien on a liquor license? The bankruptcy court rules yes. State law determines property interests in bankruptcy and whether security interests exist in a debtor's assets. *In re Submicron Systems*, 432 F.3d 448, 458 (3d Cir. 2006); *In re Kanoff*, 408 B.R. 53, 56 (Bankr. M.D. Pa. 2009). The UCC, as adopted in Pennsylvania, defines a security interest as an interest in personal property which secures payment or performance of an obligation. 13 Pa. C.S.A. § 1201(b)(35); *In re Ciprian Ltd.*, 473 B.R. 669, 673 (Bankr. W.D. Pa. 2012). Prior to 1987, the sole provision of the Liquor Code addressing whether a liquor license is considered property, 47 P.S. § 4-468(b.1) ("section 4-468(b.1)"), provided that, when a license is placed for safekeeping with the Pennsylvania Liquor Control Board ("the Board"), "the license shall continue as a personal privilege granted by the board and nothing herein shall constitute the license as property." 47 P.S. § 4-468(b.1); *see 1412 Spruce Inc. v. Pennsylvania Liquor Control Board*, 504 Pa. 394, 397, 474 A.2d 280 (1984).

On July 1, 1987, however, the Pennsylvania Legislature amended 47 P.S. § 4-468 to add a new section specifying that "[t]he license shall constitute a privilege between the board and the licensee. As between the licensee and third parties, the license shall constitute property." 47 P.S. § 4-468(d). Section 4-468(b.1) has not been repealed. The Bankruptcy Court held that the plain language of the Amendment made liquor licenses "property" between Third Parties and licenses. Because there was a fully executed security agreement between the debtor and the lender, which specifically identified the liquor license as collateral, even though the filed UCC-1 Financing Statement only mentioned "all property of the debtor" the court held that the lender had a valid lien in the liquor license.

In re Heiser, 2019 WL 919732 (Bankr. M.D. Pa, 2019)(per Opel, J.)

Can a land sale contract be treated as a secured lien in a Chapter 13 and provided for under the plan pursuant to 11 U.S.C. §1325(a)(5)? The Debtor in this case defaulted on the land sale contract prior to the filing and a judgment for eviction was entered against her. She subsequently filed a Chapter 13 case and sought to cure the arrearage owed on the loan through her Chapter 13 plan. The Seller (Fanella) and the Trustee objected to confirmation of the plan based on the anti-modification provisions of 11 U.S.C. §1322(b)(2). The court first looked to the substance of Fanella's claim and determined that Fanella's interest in the real estate was intended to secure her debt and therefore that interest constituted a lien as defined by 11 U.S.C. §101(37). Next the court reviewed the substance of the objection filed by Fanella that Debtor's proposed plan impermissibly modified her

secured claim in violation of 11 U.S.C. §1322(b)(2). Both parties acknowledged that the real estate in question functioned as Debtor's primary residence. As such, Fanella argued that Debtor was prohibited from modifying the contract. In response, the Debtor argued that she may employ 11 U.S.C. §1322 (c)(2), to extend the term of the installment contract and pay it over the life of the plan. The Court agreed with the Debtor, denied confirmation of the instant plan and gave Debtor thirty days to file an amended plan.

Means Test (Disposable Income)

In re Kohli, 2018 WL 3098738 (Bankr., M.D. Pa, 2018)(per Thomas, J.)

Disposable Income in Chapter 13 Determined by Form 122C Modifiable Only Upon Showing of Significant Changes to Anticipated Income

Disposable Income for Chapter 13 confirmation purposes [§1325(b)(1)(B), and (2)] is generally determined by Form 122C, i.e., based upon a debtor's historical financial condition. Schedules I and J on the other hand, are "future-looking".

Debtor's Form 122C-1 indicated disposable income of \$679.82 per month or more than \$40,000 over 60 months [Debtor had above median income], an amount she insisted she could not pay. Rather, she sought to confirm a plan based upon Schedules I and J which resulted in excess income of \$371 per month. Debtor provided no evidence to suggest that there were significant financial changes in her anticipated financial condition. Indeed, I and J did not include deductions taken on Form 122C for real estate and vehicle expenses claimed for which she was not liable. Had she presented appropriate evidence, the Court would have considered it as allowed under *Hamilton v. Lanning*, 560 US 505 (2010). Accordingly, confirmation of her Plan based upon the \$371 per month was denied.

Mortgage Litigation

Wells Fargo v. Winnecour (In re Wells Bank), 2019 WL 642850, (Bankr.W.D. Pa. 2019)(per Taddonio, J.)

Wells Fargo, the Chapter 13 Trustee and selected debtors filed a joint motion to seal a settlement agreement regarding certain claims brought against Wells Fargo for RESPA disputes. The sole reason for attempting to seal the documents was a concern that disclosing the amounts to be paid to the Trustee and debtors would risk setting a minimum damages guideline in future cases brought on behalf of other debtors with similar cases. Pursuant to 11 U.S.C. 107(a), documents filed with the court are public records and there exists a presumption that such documents and bankruptcy filings are to be made available to the public. However, there are exceptions to this presumption set forth in §§107(b) and (c) which are designed to protect certain entities and individuals. The specific exemptions are as follows: (1) protection of the identity of a minor; (2) protection of personal identifiable information; (3) protection of a person about whom scandalous or defamatory material is contained within the subject documents; or (4) protection of an entity with regard to trade secrets, confidential information, research, development or commercial information. The burden of proving the existence of one of these exceptions is on the moving party. Here, Wells argued that the information to be sealed falls within the exception for commercial information. However, the court found that commercial information is only a relevant

exemption when it impacts the entity's ability to function and protect its information from competitors. The fact that the entity seeks to conceal information concerning its business affairs that has nothing to do with exposing information which could be used as a competitive advantage precludes a finding in its favor. Accordingly, the Court held that Wells Fargo's intent to protect its bargaining leverage in resolving future lawsuits was not enough to overcome the presumption of §107(a) and the terms of the settlement would not be sealed.

In re Faulkner, 2018 WL 4810673, at *1 (Bankr. E.D. Pa., 2018) (per Frank, J.)

Introduction

M&T Bank ("Bank") filed a proof of claim ("POC") for the mortgage secured by Debtor's home ("Home"). In response, Debtor filed an eight-count adversarial complaint requesting disallowance of the Bank's POC and damages under the legal theories of Rooker-Feldman; Res Judicata; Standing; the Merger Doctrine; Pennsylvania Act 6 of 1974 ("Act 6"); damages for Breach of Contract, violation of the Pennsylvania Unfair Trade Practice and Consumer Protection Law ("UTPCPL"); and the Federal Fair Debt Collection Practices Act ("FDCPA"). The Bank filed a 12(b)(6) Motion to Dismiss ("Motion") asserting an enforceable right to collect the debt embodied in the POC, and that Debtor's claim(s) lacked merit as a matter of law.

The Court granted the Bank's Motion as to Debtor's claims under Rooker-Feldman, Res Judicata, and affirmative damages for Breach of Contract. The Court however denied the Bank's Motion to dismiss the Debtor's claims regarding the Bank's standing to enforce the Note; the Merger Doctrine; Act 6; UTPCPL; and the FDCPA. A summary of the issues and the Court's holdings in Debtor's favor are set forth below.

Authority to enforce the Note. Did the Debtor set forth allegations sufficient to establish a claim that the Bank lacked authority to enforce the Note because it was not in possession of original Note? **Yes.** A party establishes authority to enforce the Note by being either the holder in possession; the non-holder in possession, or formerly in possession of a Note that was destroyed, lost, or in the wrongful possession of an unknown person. Debtor argued that the Bank was neither in possession of the Note, nor the holder of the Note because it did not have possession of the original Note. The Court held that a copy of the original Note does not overcome the requirement that the Court accept as true the Debtor's allegations that the Bank does not have possession of the Note.

Merger Doctrine. Did the Debtor set forth allegations sufficient to establish a claim that the Bank's 2017 mortgage POC should be partially disallowed under the Merger Doctrine, because it included fees **after** a 2003 foreclosure judgment? **Yes.** When a foreclosure judgment is entered, the mortgage contract merges into the judgment, and the right to collect pre and post-judgment charges provided for by the mortgage are extinguished. In 2003, a foreclosure judgment was entered against the Debtor. In 2017, the Debtor filed her fourth Chapter 13, and the Bank filed a POC that included charges **incurred after** the 2003 Judgment. The Court held that after entry of the 2003 Judgment, the Bank was bound by the foreclosure rights it acquired from entry of the judgment, and the 2017 POC could be partially disallowed.

Vacatur of default judgment by praecipe. Whether Pennsylvania Rules of Civil Procedure expressly permit a mortgage foreclosure default to be vacated by filing a praecipe-to-vacate judgment? **No.** The Court held that vacatur of a mortgage foreclosure default judgment by praecipe, without the consent of the defendant, and without notice and an opportunity to be heard, is not authorized by the Pennsylvania Rules of Civil Procedure and is legally ineffective. In 2010, the Bank filed a praecipe-to-vacate the 2003 mortgage foreclosure default judgment. The praecipe however was not served on the Debtor, and the judgment was vacated by the prothonotary without judicial involvement.

Act 6 violation. Did the Debtor set forth allegations sufficient to establish a claim that the Bank violated the procedural notice provisions under Act 6, 41 P.S. Sections 403(a) and 406(2)(3), that entitled the Debtor to a reduction of attorney fees included in the Bank's POC? **Yes.** Essentially, Sections 403(a), and 406(2)(3) prohibit a lender from commencing any legal action, including residential mortgage foreclosure, or contracting for or receiving attorney fees unless the debtor is given at least 30 days advance notice of the intent to foreclose. The Debtor sought disallowance of legal expenses the Bank included in the POC based on the assertion that the foreclosure action was not preceded by a pre-foreclosure notice that complied with the requirements of Act 6. The Court held that the Debtor may be able to remove attorney fees from the POC because they were incurred in connection with legal proceeding that failed to comply with the notice requirements of Act 6.

UTPCPL violation. Did the Debtor properly allege a claim under Pennsylvania's UTPCPL statute when the Bank charged the Debtor a fee for federal loss mitigation services that were free of charge? **Yes.** In general, the UTPCPL creates a private right of action for recovery of actual and treble damages, for any person who suffers any ascertainable loss of money, real or personal property, as a result of justifiable reliance upon a deceptive act or practice declared unlawful under the UTPCPL. Debtor claimed that the Bank did not advise her of the availability of HAMP, partial claims, and other loss mitigation services. Instead, the Bank demanded payments in order to qualify the Debtor for a special forbearance program for which Debtor was already eligible. The Court determined that if the facts were proven, the Debtor could establish a claim under the UTPCPL. Moreover, in reaching this conclusion, the Court held that deceptive mortgage servicing conduct that causes a borrower to submit payments establishes a UTPCPL claim.

FDCPA violation. Did the Debtor allege a viable cause of action that the Bank acting as a debt collector engaged in unlawful collection actions under the FDCPA when it attempted to collect the debt under the Note? **Yes.** One of the ways in which an entity can be defined a debt collector under the FDCPA occurs when a business regularly attempts to collect the debts of another. The Debtor alleged that since the Bank does not possess the Note, as argued above, its efforts to collect the debt were arguably actions of a debt collector attempting to collect the debts of another. Next, unfair debt collection or attempts to collect a debt include, among others, the collection of any amount (including any interest, fee, charge, or expense incidental to the principal obligation) unless such amount is expressly authorized by agreement creating the debt or permitted by law. The Debtor argued that the Banks attempt to collect debt excluded under the Merger Doctrine, legal expenses in violation of Act 6, and fees illegally collected under the UTPCPL constitute unfair and actionable debt collection activity that violate the FDCPA. The Court held that it must accept Debtor's allegation as true and found that the Motion raises a factual issue that

cannot be resolved under Rule 12(b)(6).

In re Ransom, 599 B.R. 791 (Bankr. W.D. Pa., 2019(per Agresti, J.)

A loan servicer is subjected to contempt sanctions for failing to provide “complete loan histories.” It started two years before when Ocwen filed a *Notice of Post-Petition Fees and Costs* including \$400 for legal fees to a firm not licensed in PA, to which the Chapter 13 Trustee objected. The Court rejected a resolution simply waiving the fees, fearful that the assessment was not an isolated error. A Court directed investigation found at least 30 cases of similarly imposed fees, whereupon the Court ordered an explanation and “complete loan histories” in the disclosed cases. The error was explained as a “manual error” [i.e., no one “manually” removed the computer-generated fee] and the Court was assured that the law firm was no longer involved [all of which conduct may not have been fully excusable]. Unfathomably, Ocwen failed more than once to provide “a complete loan history from the inception of the loan” as ordered, insisting upon providing either redacted accounts or post-petition histories. Improvident appeals of default orders entered in Show Cause hearings (despite Ocwen having record legal representation) further exacerbated the problem and proceedings for the Court, the Trustee, and debtor counsel.

After two years of repeated hearings attended by Ocwen in-house and outside counsel, the Court found Ocwen had knowledge of the orders to provide the data (notwithstanding the assertion that its counsel did not so advise) and had intentionally disobeyed. Accordingly, Ocwen was held in contempt for failing to provide the ordered information subjected to sanctions including perhaps as much as \$70,000 payable to The Chapter 13 Trustee and respective Debtor counsel.

Post-Petition Mortgage Counsel Fees

Quicken Loans vs Winnecour (In re Dworek), 589 B.R. 267 (Bankr.W.D. Pa. 2018) (per Agresti, J.)

The Chapter 13 Trustee filed motions in three separate cases objecting to a residential mortgage lender’s attempt to charge attorney’s fees after the lender filed Notices of Post-Petition Mortgage Fee, Expenses and Charges pursuant to Federal Rule of Bankruptcy Procedure 3002.1(c). In each of those cases, the lender was seeking reimbursement of attorney fees where no mortgage foreclosure had been filed pre bankruptcy. Such action is a violation of Act 6. *Act 6* refers to the Act of January 30, 1974, P.L. 13, No. 6, officially titled as the *Loan Interest and Protection Law*, *Act 6* is codified at *41 P.S. §§ 101 et seq* . Of particular relevance here is *41 P.S. § 406(3)*, which provides that for residential mortgages no attorney fees may be charged by the mortgagee for legal expense incurred prior to commencement of "foreclosure or other legal action." Among the cases holding that this provision acts to prevent post-petition attorney fees from being charged by a creditor in a bankruptcy case that was filed before a foreclosure action had started, *see* , *In re Graboyes* , 223 Fed. Appx. 112 (3d Cir. 2007), *In re DeTone*, 262 B.R. 359 (Bankr.W.D. Pa. 2001), and *In re Stanley*, 2018 WL 2979852 (Bankr. M.D. Pa., June 12, 2018). After discovery, prior to the hearing the lender attempted to withdraw the Notices without prejudice. The Court refused, holding that a lender cannot voluntarily withdraw a Notice of Post-Petition Fee without prejudice once the matter is being litigated. Moreover, the Court opined that the lender’s attempt to seek attorney’s fees in violation of Act 6 was a

clear Rule 9011(b)(1) violation.

In re Meyer, 596 B.R. 172 (Bankr. M.D. Pa., 2019)(per Opel, J.)

Issue: Should summary judgment be granted in a dispute over post-petition fees where no notice was filed?

The Debtor brought an adversary proceeding against the mortgage creditor for attempting to collect late fees, corporate advances, and escrow advances without giving any notices pursuant to Fed. R. Bankr. P. 3002.1(c) and for violation of the discharge injunction. The creditor moved for summary judgment. The Court granted summary judgment with respect to \$1,300 in late fees stating the fees were incurred pre-petition or after the granting of stay relief where notices are not required. The Court denied summary judgment as to additional late fees, corporate advances and escrow advances due to a genuine material issues of fact as to the classification of the various charges and when the charges were incurred. The Court also denied summary judgment as to the discharge injunction on grounds there were material issues of fact.

Proof of Claim Litigation

In re Waldorf, 2018 WL 4998117 (Bankr.E.D. Pa. 2018) (Coleman, J.)

A Chapter 13 Debtor objected to his ex-spouse's priority proof of claim for legal fees relating to their pre-petition divorce proceeding arguing that it was not a "domestic support obligation" under §§ 101(14A) and 507(a)(1)(A), but rather a general unsecured claim. The Court cited multiple factors as outlined in *In re Gianakas*, 917 F.2d 759 (3d Cir. 1990) to determine whether an obligation is in the nature of alimony, maintenance or support. However, the Court focused mostly on the financial disparity of the two parties and inferred unarticulated intent from the state court in concluding that the award was in the nature of support. The Bankruptcy Court also rejected the Debtor's argument that a portion of the claim should not be a priority claim because the ex-spouse had filed her own bankruptcy discharging her obligation to pay the very attorney's fees at issue. **QUERY: Is the ex-spouse obtaining a windfall being able to collect from the Debtor that is not legally owed.**

In re Simpson, No. 2019 WL 1453069 (Bankr.W.D. Pa. 2019)(per Taddonio, J).

Facing the impending foreclosure of her primary residence by Wells Fargo Bank, N.A., the Debtor filed a chapter 13 case to prevent the sale of her home. Unable to reach a consensual resolution with Wells Fargo, she objected to its claim, asserting a litany of challenges ranging from the calculation of the outstanding obligation to its standing to enforce it. The bankruptcy court overruled the objection citing *res judicata*, as Wells Fargo had already obtained a foreclosure judgment against the debtor, as such it had standing to file its claim.

Davis v. Bank of America, (In re Davis), 597 B.R. 770 (Bankr.M.D. Pa. 2019)(per Opel, J).

A *pro se* Chapter 13 Debtor filed a Complaint which challenged a pre-petition state court judgment in mortgage foreclosure by the Defendant/Bank. The Bankruptcy Court granted the Defendant's Motion to Dismiss for lack of subject matter jurisdiction in accordance with the Rooker-Feldman doctrine. The court further explained that a prior chapter 7 discharge

only relieves the debtor of personal liability, it does not discharge an in rem mortgage which secures the obligation. *Johnson v. Home State Bank*, 501 U.S. 78, 82, 111 S. Ct. 2150, 2153 (1991) (the Bankruptcy Code provides that a creditor's right to foreclose on the mortgage survives or passes through the bankruptcy); see also *In re Reed*, 274 B.R. 155, 158 (Bankr. W.D. Pa. 2002).

Trustee Fees

In re: Yovtcheva, 590 B.R. 307 (Bankr. E.D. Pa. 2018)(per Chan, J.)

Debtor's ex-husband died shortly after the Chapter 7 Petition was filed giving rise to a \$250,000 insurance benefit payable on a disclosed policy. Trustee engaged counsel to collect the proceeds. The Debtor--self-described as a "homeless immigrant with children" trapped in poverty"-- and UST objected to counsel's \$18,600 fee application. Neither the Trustee nor counsel provided testimony.

The Court found that a significant portion of what counsel did was "non-legal" work that should have been performed by the trustee as part of his Section 704 duties, and that counsel did not exercise reasonable judgment in the use of his services, e.g., billing \$600/hour for routine tasks, e.g., filing CNRs. The application was reduced to \$7,206.

To the extent the trustee's duties have a "legal nature to them", to grant a trustee's commission and separate counsel legal fees would be "double dipping" against estate property. That counsel was doing as instructed is not enough to allow a fee; it is the trustee's duty to, *inter alia* [Section 704(a)]:

Collect and reduce to money property of estate; Insure debtor performs his obligations; Investigate the debtor's financial affairs; Examine and object to POCs; If appropriate, object to discharge; and furnish information about estate administration.

Only when the trustee runs into difficulty or there is a genuine need for legal enforcement should counsel become involved. The Court noted counsel's "non-legal" work that should have been done by the trustee without separate legal counsel:

- a) Initial review of claims;
- b) "routine" communication with creditors [and the insurer]; and
- c) Initial demand letters.

Then there was the court's meticulous determination of "excessive" time spent to become "familiar with the case", obtaining a death certificate, and duplicate reviews and investigations. The Court determined that of the 24.7 hours billed to counsel (as opposed to the paralegal) only 2.2 hours were spent on "legal services", namely, the attorney retention motion and a "routine" turnover motion against the insurance carrier.

Withdrawal of the Reference

Miller v. Eicher (In re Miller), 2018 WL 6696867 (W.D. Pa. 2018)(Baxter, J.)

A Chapter 13 Debtor filed an adversary action against a contractor in bankruptcy court alleging shoddy construction and asserted various state court claims. The Defendant

contractor demanded a jury trial and refused to agree to have the bankruptcy court try the case. District Courts typically defer withdrawing of the reference in this types of matters until all discovery and pretrial matters are concluded and the matter is ready for trial. Because this matter was trial ready, to protect the defendant's seventh amendment right to a trial by jury, the District Court withdrew the reference of the adversary action.

Chapter One
Section 2

Top Consumer Bankruptcy Cases – Middle District

David L. Buchbinder, Esq.
US Department of Justice
Wilmington, DE

Top Consumer Bankruptcy Cases Middle District June 1, 2018 – May 31, 2019

Dischargeability Issues

Smith v. Johnson-Battle (In re Johnson-Battle), 599 B.R. 769 (Bankr. D.N.J. 2019)

Debtor and Landlord entered into a stipulation to reduce the Debtor's unpaid rent of almost \$12,000 to \$6,000, payable in equal installments over one year. If the Debtor defaulted, the amount would increase to \$12,000. At the time of the settlement, the Debtor represented that she was single with one income. The Debtor was in fact married the entire time, although she and her spouse were informally separated off and on. Based upon the Debtor's false representations, the landlord filed a complaint seeking a ruling that the entire unpaid amount under the stipulation (\$8,088.23) was excepted from discharge pursuant to 11 U.S.C. § 523(a)(2)(A). At trial, the Debtor's husband testified that he still lived in the home with the Debtor and helped to pay the mortgage. The Debtor was a teacher and was only unemployed temporarily when the stipulation was entered into because it was summer vacation. The entire amount was found to be nondischargeable based upon the Debtor's misrepresentations at the time of the settlement. *See also Archer v Warner*, 538 U.S. 314 (2003).

In re Peralta, 599 B.R. 759 (Bankr. D.N.J. 2019)

The debtor filed a Chapter 7 petition to stay a pending state court fraud action. The plaintiffs in the action were properly served with the Notice of Bankruptcy Filing advising them of the deadline to file complaints objecting to the dischargeability of a debt. The plaintiffs, who were not proficient in English, took the notice to their attorney in the fraud action, Mr. Blanch. He did not file a complaint objecting to dischargeability or a motion to extend time to file a complaint before expiration of the deadline to do so. Seven months later a motion was filed seeking leave to file a dischargeability complaint. The motion contended that the plaintiffs' lack of English proficiency constituted cause to grant the motion.

The court denied the motion. It was undisputed that the plaintiffs were properly served with the Notice of Bankruptcy Filing. There is no requirement that the notice be in a language other than English. Nor is there an obligation to list a creditor's attorney in a list of creditors or schedules. The Court noted that their attorney took no action whatsoever after his clients brought them the Notice of Bankruptcy Filing, stating: "While the Court understands the Movants' frustration with not receiving a response from Mr. Blanch, his silence did not, and does not, render the bankruptcy notice inadequate."

***In re Sevastakis*, 591 B.R. 197 (Bankr. D.N.J. 2018)**

Creditor obtained a state court judgment in the amount of \$761,527 against the Debtor for fraud, breach of contract, and violations of the New Jersey Consumer Fraud Act (N.J.S.A. § 56-8, *et seq.*). The state court found that the Debtor made multiple misrepresentations, including forging the plaintiff's name on a permit application, failing to advise the plaintiff he would need to hire a licensed architect; debtor's representing that he could draw the plans, and failure to comply with the building code.

On cross motions for summary judgment, the Court rendered judgement in favor of the creditor. The issue was whether or not the trial court had made a finding of intent, an essential element of a Bankruptcy Code Section 523(a)(2) complaint. Since the New Jersey Consumer Fraud Act is a strict liability statute, proof of intent is not required, and the Debtor argued there was no finding of intent. The Bankruptcy Court observed that a creditor cannot rely solely upon the New Jersey Consumer Fraud Act in a dischargeability action for this reason, but the state court made numerous findings of actual misrepresentations by the Debtor, including outright lies.

Because the state court found intent, the Rooker-Feldman doctrine was then applied, resulting in judgment in favor of the creditor.

In this case, the court also discussed complaints against contractors under section 523(a)(2)(A) and how fraud is distinguished from poor workmanship or quality of the product: "In cases involving a debtor-contractor before this Court, courts in this Circuit have generally recognized 'two ways to establish misrepresentation or fraud under section 523(a)(2)(A): (1) to show that the contractor executed the contract never intending to comply with its terms, or (2) to demonstrate that the contractor intentionally misrepresented a material fact or qualification when soliciting the work.'" 591 B.R. 203 (citations omitted).

Chapter 13 Vehicle Turnover and Adequate Protection

***Denby-Peterson v. NU2U Auto World et al.*, 595 B.R. 184 (D.N.J. 2018)**

Debtor purchased a used 2008 Corvette but failed to timely pay \$2,491 for taxes and license. The sale contract provided that if the payment was not made, weekly payments would be applied to the taxes and fees until paid. Creditor did not properly apply the payments and instead repossessed the car. The Debtor filed a Chapter 13 petition one week later and sought to have the vehicle returned to her. The creditor opposed, taking the position that Debtor never had title to the car and that it was not property of the estate. The Bankruptcy Court ruled that the car was property of the estate, should be returned to the debtor upon her proof that the vehicle was properly insured, and the creditor was ordered to account for the Debtors' personal property that was in the car at the time of the repossession.

The Debtor sought sanctions that the Bankruptcy Court declined to award. The debtor appealed from the Bankruptcy Court's opinion of *In re Denby-Peterson*, 576 B.R. 66 (Bankr. N.J. 2017). After briefing for the appeal was complete, the debtor's underlying Chapter 13 case was dismissed. The District Court entered an Order to

Show Cause why the appeal was not mooted by dismissal of the underlying case.

The Court found the appeal to not be moot, providing numerous citations holding that a motion seeking sanctions for a violation of the automatic stay survives dismissal of the underlying case.

The Court affirmed the Bankruptcy Court ruling declining to award sanctions. The Court observed that the stay was violated when the creditor did not immediately return the vehicle. However, numerous cases also hold that it is not a violation of the automatic stay to maintain the status quo, including *Carr v. Security Sav. & Loan Ass'n*, 130 B.R. 434 (D. N.J. 1991), holding that a creditor may hold a vehicle until provided with proof of adequate insurance coverage. The Court stated: “In this case, the Court finds a creditor has not violated an automatic stay for retaining a vehicle lawfully seized prepetition, as long as the debtor has not produced an insurance policy denoting the creditor as the loss payee.”

Finality of Confirmed Plans

***In re Galluzzo*, No. 06-15392-SLM, 2018 WL 4191476 (Bankr. D.N.J. Aug. 15, 2018)**

Debtor filed an individual Chapter 11 petition in 2006. His assets included two pieces of real property. Their debts included IRS priority and unsecured claims of \$1,277,594.57. In 2008 the Debtor confirmed a plan which included a settlement of the IRS claims. The IRS agreed to reduce its claim by \$200,000, the balance to be secured by junior liens in two real properties owned by the Debtor. The Debtor and the IRS entered into a stipulation which the Court approved in addition to confirming the Debtor’s Plan. The Chapter 11 case was closed in 2010.

Post-Confirmation, the Debtor filed repeated suits seeking to abate or reduce the tax claims. In 2011, the Debtor filed suit against the IRS alleging that the taxes had been erroneously assessed. This complaint was dismissed upon motion by the IRS. Next, the Debtor filed a petition for redetermination of the tax in the tax court. The tax court dismissed the case finding that it lacked jurisdiction because the petition had not been timely filed. The Third Circuit affirmed. In 2015, the Debtor filed another complaint against the IRS, this time seeking to have the liens against the real properties released. This case was dismissed for failure of the Debtor to have exhausted their administrative remedies.

In 2016, the IRS filed a motion to reopen the Chapter 11 and enforce the terms of the Plan. The Debtor contended there were not appropriate factual findings in connection with the earlier confirmation of the Plan, and they continued raising issues they had attempted to raise in the earlier actions taken outside of the Plan.

The Court ruled against the Debtor. The Debtor never objected to the IRS claim in the bankruptcy and made a deal with the IRS which the Court approved. The Court noted that the confirmation order is binding and also acts as *res judicata* with respect to matters decided in the Plan. The Court stated:

“Now that the time has come to pay the claim, Debtor no longer likes the deal he struck. Debtor cannot take all the benefits of a confirmed Chapter 11 plan and then discard the burdens. To permit

Debtor to prevail on such nonsense is antithetical to his original interest in concluding his bankruptcy case and the finality established by the Stipulation and Order and Confirmation Order. Debtor made his bed and must now lie in it.”

Scheduling Assets

***Danise v. Saxon Mortgage Services, Inc.*, 738 F. App’x 47 (3d Cir. 2018)**

Debtor filed a Chapter 13 petition in 2010. In her schedules, she did not disclose any potential claims against her mortgage lender. Shortly after receiving her chapter 13 discharge in 2015, she filed suit in Superior Court against Saxon Mortgage, claiming breach of contract in connection with the pre-petition denial of her application for a permanent loan modification. The District Court dismissed her complaint pursuant to Rule 12(b)(6) based upon judicial estoppel. In an unpublished opinion, the Third Circuit sustained the dismissal, finding that she had not scheduled the claim at any time in her chapter 13 case, nor had she objected to Saxon’s claim. Noting that the Debtor was able to discharge significant debt through her chapter 13 case, the Court found that concealing the claim so she wouldn’t have to share any recovery with her creditors was bad faith. Finally, the court also noted its own prior ruling that a debtor has an affirmative duty to disclose claims a debtor may possess against third parties. See *Krystal Cadillac-Oldsmobile GMC Truck, Inc. v. Gen Motors Corp.*, 337 F.3d 314 (3d Cir. 2003).

Foreclosure Issues

***In re Smith*, 599 B.R. 266 (Bankr. D.N.J. 2019)**

Manasquan Savings Bank obtained a foreclosure judgment against the Debtor in January of 2017 in the amount of \$307,632.33. A Sheriff’s Sale was scheduled for June 19, 2017 was postponed multiple times. On December 11, 2017 the Debtor filed a Chapter 13 case and converted it to a chapter 7 on January 3, 2018. The chapter 7 trustee then conducted an auction in open court for the sale of the Debtor’s home, receiving a high bid in excess of \$1 million. At the closing, the Sheriff asserted a right to its statutory commission. The trustee and the Sheriff agreed that the matter could be decided by summary judgment. The issue was whether the Sheriff would be entitled to a statutory commission where the sale was ultimately conducted by the chapter 7 trustee.

A sheriff’s right to compensation is governed by N.J.S.A. 22A:4-8 and provides in pertinent part: “When the execution is settled without actual sale and such settlement is made manifest to the officer, the officer shall receive ½ of the amount of percentage allowed in the case of sale.”

The court distinguished a chapter 7 liquidation from a chapter 13 reorganization where at least two courts have held that chapter 13 repayment plan is not a settlement for purposes of the above statute for to do so would impose a Sheriff’s fee on every chapter 13 debtor who proposes to cure defaults on mortgages. See, for example, *In re Dominguez*, No. 05-32129-NLW, 2006 WL 4452976 (Bankr. N.J. April

7, 2006). A sale, however: “if conducted by a chapter 7 trustee, before a sheriff completes his duties, is a ‘settlement’ within the meaning of N.J.S.A. 22A:4-8. The Sheriff is entitled to [half] of the amount of the percentage allowed thereby.” The court then capped the Sheriff fee based upon the amount paid to the mortgage lender and not on the entire sales price stating: “Therefore, it is only natural that the amount of the sheriff’s commission should be based on the amount realized on behalf of the creditor.”

***In re Goione*, 595 B.R. 477 (Bankr. D.N.J. 2019)**

Lender obtained a foreclosure judgment on May 11, 2017. Thereafter, the Debtors filed three bankruptcy cases, the first two being dismissed. The Debtors third petition was filed five days before a scheduled Sheriff’s sale. The Debtors obtained an order staying the Sheriff sale. Sale of the home closed on October 31, 2018. The lender demanded a payoff of \$1,038,268.99. The Debtors claimed the payoff should be the lesser amount of \$920,994.26. The difference in amount resulted from the lender seeking its contract rate of interest vs judgment rate interest, and a request for attorney fees incurred after entry of the foreclosure judgment in 2017.

The lender contended that Section 506(a) of the Bankruptcy Code entitled it as secured creditor to all of its interest fee and other charges. The Debtors contended that the doctrine of merger extinguished the lender’s rights to contract interest and post-judgement attorney fees.

The Court ruled in favor of the Debtors. Citing long established case law, the Court first holds that the doctrine of merger: “entitles a post-judgment mortgagee to the legal rate of interest rather than the rate specified in the mortgage, because the mortgage’s terms providing for contractual interest rate no longer exist.”

Because the loan documents did preserve a right for the lender to seek post judgment attorney fees, the lender’s fees were allowed, albeit in a reduced amount.

The Court also noted that had the Debtors proposed a plan to cure and reinstate the mortgage, then Bankruptcy Code Section 122(c)(1) would require the Debtors to pay the contract interest rate and the post-judgment attorney fees.

***Lulu Belle Flamer v. Wells Fargo Bank*, No. 1:18-cv-11414, 2019 WL 2082961 (D.N.J. May 13, 2019)**

Pro se Debtor filed Chapter 7 with a foreclosure action pending against her home. She answered the foreclosure action claiming an accord and satisfaction. Shortly thereafter she received her discharge. The discharge notice clearly stated that a lien against the property would remain enforceable unless avoided or eliminated.

In the state court foreclosure action, the Debtor contended that her bankruptcy discharge extinguished the lien because the discharge was entered prior to the foreclosure judgement. The state court ruled against her. The Debtor then filed a Chapter 13 petition and filed an adversary proceeding against the bank to determine the validity of the bank’s lien. The bank’s motion to dismiss was granted and the Debtor appealed.

The Court found that all four elements of the Rooker-Feldman applied to preclude the Debtor from relitigating the foreclosure action. The Debtor lost in state court. The Debtor's complaint related directly to the state court judgment. The foreclosure judgment was entered prior to the filing of the adversary proceeding, and the Debtor as plaintiff was seeking review of the state court judgment. The Court affirmed the Bankruptcy Court and dismissed the complaint with prejudice.

***In re Mendez*, 600 B.R. 321 (Bankr. N.J. 2019)**

Debtor objected to attorney fees sought by lender as unreasonable and in excess of statutory fees permitted pursuant to New Jersey's Fair Foreclosure Act (N.J.S.A. 2A:50-53 *et seq.*) and New Jersey Rule of Court 4:42-9(a). The lender cross-moved for relief from stay, contending that the Debtor's position violated the anti-modification provisions of Bankruptcy Code Section 1322(b)(2). The underlying foreclosure judgment awarded fees of \$1,766.39. The lender's proof of claim in the bankruptcy sought fees of \$32,939.81.

The Court found that, absent the agreement of the lender, the debtor may only propose a plan to cure the default or pay the entire debt because these are the only choices which Bankruptcy Code Section 1322(c) provides. Section 1322(c) (1) allows a debtor to cure defaults up to the time of a foreclosure sale. Section 1322(c) (2) permits the debtor to reinstate the obligation but the debtor is then obligated to pay the full contractual amount of fees. Should the plan propose to cure the default, the lender's attorney fees are limited to the amount of fees in the judgment. Should the plan propose to pay the claim over the life of the plan, then the entirety of the attorney fees could be due.

The Court distinguished this case from *Goione*, *supra*, because here, the underlying documents did not evidence an intent that the Debtor would continue to be responsible for fees after a foreclosure judgement. With respect to the reasonableness of the fees, the Court remanded the matter back to state court to determine the intent of the parties with respect to post foreclosure judgment attorney fees. Whatever the NJ court ultimately awards as fees is what the Debtor has to pay in a plan.

***In re Coppola*, 596 B.R. 140 (Bankr. D.N.J. 2018)**

In 2006 the Debtor borrowed \$371,000, secured by a mortgage in her home. In July of 2017, a judgment of \$452,684.38 was entered. The Debtor filed a Chapter 13 petition in March of 2017 and applied for loss mitigation, it being undisputed that a plan could not be confirmed without a loan modification. The Debtor submitted a loan modification to the bank which was rejected on the ground that the Debtor's income was too low. The Debtor complied with the appropriate regulations and advised the bank it was in error because it had not correctly taken her income into account and did not give any credit to the income of her non-debtor spouse. Instead, the bank attempted to steer the Debtor into a short sale.

The Debtor filed an adversary complaint against Wells Fargo Bank, alleging that the bank did not properly process or respond to the Debtor's application for a loan modification, resulting in alleged violations of federal and state statutes and regulations. The Debtor pleaded claims under RESPA (12 U.S.C. § 2601, *et seq.*), the

New Jersey Law Against Discrimination (N.J.S.A. § 10:5-12) and the New Jersey Consumer Fraud Act (N.J.S.A. § 56:8-2 *et seq.*). The bank moved to dismiss.

The issue before the Court was whether there is a private right of action for violations of RESPA and its related regulations. The Court found that RESPA contains an express private right of action codified at 12 U.S.C. § 2605(f). The Court found the allegations that the bank's failure to provide specific reasons for denial of the loan modification stated a claim for relief under RESPA. However, the Court did not find the facts to allege a claim under the New Jersey Law Against Discrimination, and consequently, under the New Jersey Consumer Fraud Act but did grant the Debtor leave to amend.

Proofs of Claim

***In re Campanile*, No. 17-24902-JNP, 2019 WL 968095 (Bankr. D.N.J. Feb. 25, 2019)**

The Debtor filed a Chapter 13 petition in July of 2017. The claims bar date was set for November 22, 2017. Eagle One, a junior mortgagee, was listed in the schedules. The Debtor's plan was confirmed on April 5, 2018. The plan provided for no payments to Eagle One and provided that the claim would be unaffected by the plan. Eagle One did not file a proof of claim. Wells Fargo Bank, the senior lender, was granted relief from the stay and foreclosed on the property in June 2018.

Eagle One then filed a motion to file a late claim which the court denied. Eagle appealed. Eagle One then filed a motion for relief from the stay to permit it to seek a deficiency judgment against the Debtor, and for permission to then file a proof of claim based upon the judgment.

The first issue approached by the Court was whether Eagle One's appeal of the ruling denying it leave to file a late claim divested the Bankruptcy Court of jurisdiction. The Bankruptcy Court found that it did not. Although an appeal will normally divest the trial court of jurisdiction, the bankruptcy court retains jurisdiction over the case to the extent that matters before it are unrelated to the subject of the appeal. The Court found the differences between the late claim motion and the motion for relief from stay to be sufficiently unrelated so that the Court could rule upon the motion for relief from the stay.

Eagle One contended that an exception contained within Federal Rule of Bankruptcy Procedure 3002(c)(3) permitted the late filing of a claim within 30 days from the entry of a judgment for the recovery of money or property from the entity or avoiding the entity's interest in property. The Court noted that the stated purpose of the rule is to provide creditors who have judgments entered against them with an opportunity to file a claim. Eagle One was the entity seeking the judgment and so the rule did not apply to it. Further, the foreclosure sale conducted by Wells Fargo was not a judgment against Eagle One. It simply rendered any claim Eagle One may have still had, to be completely unsecured.

Top Commercial Bankruptcy Cases

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Top Commercial Bankruptcy Cases

I. EXECUTORY CONTRACTS

Rejection of a Contract under §365 Excuses Future Performance by the Debtor, Operates as a Breach, and Gives Rise to a Claim for Damages But Does Not Rescind the Contract and the Contracting Party Retains All Other Rights Under State Law Including in this Case the Right to Use the Debtor's Trademark.

Mission Product Holdings, Inc. v. Tempnology, LLC, 139 S. Ct. 1652 (2019)

Prepared by Derek J. Baker, Esq.

The Supreme Court reversed the First Circuit in an opinion written by Justice Kagen that started with the premise that under §365 a debtor licensor's rejection of an executory trademark license relieves the licensor of any duty to perform obligations under the rejected license and results in a "breach" giving rise to damages and a claim in the bankruptcy case. The Court went on to hold that nothing in the Bankruptcy Code altered or eliminated the applicable non-bankruptcy rights of a counterparty to an executory contract. Rejection of the license does not "terminate or vaporize" the licensee's right under applicable state law to use the trademark post rejection.

Justice Sotomayor filed a concurring opinion in which she emphasized that the "continuing rights" analysis of the majority only protects a trademark licensee's rights under applicable non-bankruptcy law. If applicable non-bankruptcy law does not allow the counterparty's continuing exercise of rights under the license post-rejection, the majority's analysis may be of no benefit to the licensee.

Justice Gorsuch dissented on standing grounds. He concluded that since the trademark had expired before the case reached the Court, the case was no longer "live" for a determination. The majority rejected Justice Gorsuch's on the ground because the licensee had a damage claim resulting from the rejection of the license.

Tenant that Elects to Retain Possession of the Leased Premises Post-Rejection of the Lease Is Entitled to Assert Against a Purchaser of the Premises from the Debtor All the Terms of the Lease Including a Reduction in Rent.

IDEA Boardwalk, LLC v. Revel Entertainment Group, LLC (In re Revel AC, Inc.), 909 F3d 907 (3d. Cir 2018).

Prepared By: Derek J. Baker, Esq.

The Third Circuit, in the chapter 11 case of the failed Revel casino in Atlantic City, N.J., affirmed the bankruptcy court's ruling that a tenant who elected under §365(n) to remain in possession post-rejection of its beach club and restaurant leases was entitled against the buyer of the Revel to the benefit of any reduction in rent provided for in the leases. In addition, the court found the tenant would also be entitled to the reduction under the doctrine of equitable recoupment.

The Court reviewed the doctrine of equitable recoupment and concluded that the single transaction prong of the equitable recoupment doctrine was satisfied because the

rental obligation and the tenant's claim to a reduction in the amount due arose from the same lease transaction. The Court also noted that under established Third Circuit case law a §363(f) sale eliminates "interests" of third parties but not rights of third parties to assert defenses, including equitable recoupment, to a buyer's claim. Thus, the tenant retained the equitable claim to recoupment. Therefore, even if there was not a contractual right of recoupment, the Court would impose equitable recoupment as an equitable remedy.

The Court was quick to note that the right of recoupment would not allow the tenant to collect directly from the purchaser for any amounts. Rather, the tenant could only use recoupment to reduce its rent obligation to zero. The tenant could never use the right to collect affirmatively from the purchaser.

II. DEBTOR'S CONNECTION TO MARIJUANA ACTIVITY

Bankruptcy Court Bound to Dismiss a Debtor's Chapter 11 Case if Debtor's Ongoing Business Involvement with Marijuana Production or Marketing Post Confirmation Would Violate Federal Controlled Substances Act.

In re Way to Grow, Inc., et al., 2019 WL 669795 (D. Ct. Colo.2019), *affirming* *In re Way to Grow, et al.*, 597 B.R. 111 (Bankr. D. Colo. 2018).
Prepared by Laurie Krepto ,Esq.

The bankruptcy court dismissed the chapter 11 cases of three related debtors because the debtors were violating §843(a)(7) of Controlled Substances Act by engaging in the sale of hydroponic gardening equipment to buyers who they knew would use their equipment to grow marijuana. It is established in some Circuits that a bankruptcy court should dismiss a chapter 11 case of a debtor whose post confirmation activity would violate federal criminal law.

The district court denied a motion for a stay pending appeal on grounds of lack of showing of likelihood of success on appeal. The debtors made several arguments which were rejected by the bankruptcy court and found by the district court to be likely rejected on appeal as well, including:

- (i) manufacturing or distributing hydroponic equipment even with knowledge that it will be used for marijuana cultivation does not satisfy the statutory requirement set forth in the Controlled Substances Act;
- (ii) the bankruptcy court improperly dismissed the chapter 11 case of the debtor holding company that did not manufacture or distribute anything;
- (iii) there was insufficient evidence at trial to establish the requisite mens rea; and
- (iv) the post-petition enactment of the Agricultural Improvement Act of 2018, which lifts the ban on the commercial and industrial hemp product so long as it does not exceed certain THC percentages, would allow them to reorganize legally.

The holding company issue was waived by debtors' failure to raise the issue in the bankruptcy court and the record did not support a reasonable possibility that the debtors could survive

operating their businesses as suppliers to hemp but not marijuana products.

Bankruptcy Court Dismisses Corporation's Chapter 11 Because of the Sole Shareholder's Activity in the Marijuana Business.

In re Basrah Custom Design, Inc. 600 B.R. 368 (Bankr. E.D.MI, Southern Division)
Prepared by Lisa Rynard Esq.

Barash Custom Design, Inc. is a custom cabinet maker that is solely owned by Weam Nocha. Barash's carpentry workshops were housed in two adjacent buildings that were owned by

Nocha. Barash's carpentry workshop properties became extremely valuable because their size and location made them ideal to become a medical marijuana dispensary or other marijuana related facility once Michigan legalized marijuana.

Barash, although not the owner, entered into a long-term lease with NEW TENANT that had a \$1.2 million purchase option. Prices of real estate continued to rise. A state court adjudicated that the lease was effective and NEW TENANT had the right to purchase the properties for \$1.2 million.

Nocha caused Barash to file a chapter 11 case and to file a motion to reject the lease with NEW TENANT. The goal was to capture the increased value of the properties. The bankruptcy court denied the rejection motion because Barash was not the owner of the property—Nocha was the owner.

The federal Controlled Substances Act makes it illegal to grow, produce, or market marijuana, and to rent to people engaged in the marijuana industry. Recent cases have held the chapter 11 case of an entity that will be violating that Act post confirmation should be dismissed. The United States Trustee filed a Motion to dismiss the Barash chapter 11 case because of the Debtor's entanglement with the medical marijuana dispensary business. The bankruptcy court dismissed the chapter 11 case. Nocha initiated the chapter 11 for the sole purpose of taking advantage of the active cannabis market and renegotiating a more lucrative lease agreement for himself. The Court was particularly offended by this mis-use of the federal court system and the result was a two-year bar on refileing.

Plan that Is Proposed in Conformity with Applicable Law and Regulations Is Confirmable Under §1129(a)(3) Even If Debtor Developer Collects Rent from a Marijuana Related Business Tenant.

Garvin v. Cook Investments NW, SPNWY, LLC, 922 F.3d 1031 (9th Cir. 2019).
Prepared by Matthew Hamermesh, Esq

The Court of Appeals for the Ninth Circuit, in an opinion by Judge Margaret McKeown, held that the fact that one of the debtor's tenants had leased property to run a marijuana establishment that was permitted under state law did not mean that the plan had been proposed "by any means forbidden by law."

The United States Trustee sought to dismiss the case on the ground that the lease to the marijuana business constituted gross mismanagement, and then objected to the plan because of the lease to a marijuana related company. The U.S. Trustee continued its objection after the debtor amended the plan to reject the lease. The Court of Appeals affirmed the

bankruptcy court's decision that the plan did not violate Section 1129(a)(3), which prohibits a plan that is proposed "by any means forbidden by law." Focusing on the plain language of that provision, the court held that in deciding whether a plan violates §1129(a)(3), a court should only look at actions taken to propose the plan, not the terms of the plan.

III. CIVIL CONTEMPT

Civil Contempt May Be Imposed on a Creditor for Violating a Discharge Injunction Under §524(a)(2) Only If there Is No Fair Ground to Doubt the Creditor's Action Violates the Discharge Injunction.

Taggart v. Lorenzen, 139 S.Ct.1795 (2019)

Prepared by Derek J. Baker, Esq.

The United States Supreme Court clarified the standard to determine whether a creditor may be sanctioned for violating the discharge injunction. A chapter 7 debtor received a discharge. Estranged co-owners with debtor of a business revived litigation that was pending when the chapter 7 case was filed against the debtor and eventually obtained a judgment. The debtor returned to the bankruptcy court and sought and obtained a determination that the creditor's personal judgement against him post-discharge was for prepetition acts and, therefore, violated the discharge injunction. The bankruptcy court sanctioned the plaintiffs and the bankruptcy appellate panel, and the Ninth Circuit reversed.

The Supreme Court granted certiorari. The creditors argued sanctions may only be imposed if the actors subjectively believed their actions would violate the discharge injunction, regardless of the reasonableness of its belief. On the other hand, the debtor proposed a "strict liability" standard that if the creditor intended to take the action and the action violated the discharge, then the action itself should result in civil contempt.

In a unanimous decision written by Justice Breyer, the Court reaffirmed the long-standing principle of interpretation that when a term in a statute is borrowed from established law, ordinarily the statute should be interpreted consistently with established law. In traditional civil contexts, contempt is an appropriate remedy when there is no objectively reasonable basis to conclude that the action would not violate the injunction. The Court held that the same standard should apply in the bankruptcy discharge context. Therefore, the creditor may be held in civil contempt for violating the discharge injunction if the court concludes that there was "no fair ground for doubt" that the action taken by the creditor violated the discharge. Since the lower courts applied varying (and in all instances incorrect) legal standards, the case was remanded for a determination of whether the creditor's actions here met that standard.

IV. PROCEDURE OR JURISDICTION

Court of Claims Case Is Not a Second Chance to Relitigate Issues that Could Have Been Litigated Before the Bankruptcy Court and on Appeal from the Bankruptcy Court's Decision.

Campbell v. United States, 932 F.3d 1331 (Fed. Cir. 2019).

Prepared by Matthew Hamermesh, Esq

The Court of Appeals for the Federal Circuit, in an opinion by Judge Timothy Dyk, held that the Court of Federal Claims did not have jurisdiction to consider whether alleged coercion by the federal government for a particular result in the GM bankruptcy case constituted a regulatory taking for which the plaintiff class was entitled to compensation.

The plaintiff class consisted of individuals injured by GM vehicles with personal injury claims against Old GM. They had challenged unsuccessfully the sale of GM's assets, to an entity funded by, and at the urging of, the federal government free and clear of their claims. The plaintiffs then sued the federal government alleging that the extinguishment of their personal injury claims without compensation violated the Takings Clause of the Fifth Amendment. The Federal Circuit held that the Court of Claims – which generally has exclusive jurisdiction over claims against the federal government – did not have jurisdiction over plaintiffs' claims because that jurisdiction would constitute an improper collateral attack on the bankruptcy court's decision. The plaintiffs' remedy, the court held, was only through an appeal of the bankruptcy court's decision.

No Time Limit Is Fixed by Rule or Statute on When a Losing Party to a Disputed Motion May File a Motion for Reconsideration with the Bankruptcy Court But the Doctrine of Laches Does Apply to a Motion for Reconsideration.

In Re Energy Future Holdings Corp., 904 F.3d 298 (2018), cert. denied, 139 S.Ct. 1620 (2019).

Prepared by Derek J. Baker

In this divided panel decision, the Court of Appeals for the Third Circuit held that a district court may properly exercise discretion to "reconsider" interlocutory orders and there is no fixed time within which a motion for reconsideration must be filed.

A merger agreement between New Era Energy, the acquirer, and the Chapter 11 debtor, Energy Future Holdings and its subsidiaries, which was approved by the bankruptcy court included a termination/breakup fee of \$275 million that was payable to New Era if the Debtor terminated the agreement. Ultimately, due to the failure to secure regulatory approval, the Debtor was forced by the economic practicalities to terminate the merger agreement and seek another buyer.

New Era sought payment of the breakup fee in the bankruptcy court. On a creditor's motion for reconsideration of the order that approved the breakup fee, the bankruptcy court held it had inherent power to reconsider its prior order. In so doing, the bankruptcy court denied the request for payment of the breakup fee by limiting the payment of the fee to situations which were not currently applicable. The buyer sought and obtained a direct appeal to the Third Circuit.

Judge Greenaway, writing for himself and Judge Fuentes, confirmed that the bankruptcy court's order approving the breakup fee was an interlocutory order because the bankruptcy court retained jurisdiction to determine the allocation of the fee among the various debtors. Two key conclusions followed. First, the deadlines under Fed. R. Civ. P. 59 (14 days) and 60(b) (reasonable time/one-year) do not apply to a motion for reconsideration of an interlocutory order and because the bankruptcy court had acted within a reasonable time the doctrine of laches did not bar consideration of the motion for reconsideration. Second, the bankruptcy court correctly applied the clear error of law or fact standard, the most rigorous standard for granting reconsideration.

The Court pointed out that the bankruptcy court was not reevaluating what it should have originally determined. Rather, the Court highlighted that the bankruptcy court admitted an error in assessing the appropriateness of certain termination payments because it misapprehended when those payments would be triggered. Therefore, the Court concluded that the bankruptcy court appropriately reconsidered the order, and that doing so was not an abuse of discretion.

Judge Rendell dissented on the ground that the bankruptcy court did not really misunderstand the facts; rather, the reconsideration was simply an after-the-fact assessment meant to prevent the estate from paying \$275 million for no benefit. Judge Rendell argued that the bankruptcy court was simply reconsidering the order to prevent the application its decision to a set of facts that it did not like and never anticipated that the forced payment of the termination fee without an alternative benefit to the estate.

Federal Energy Regulatory Commission Lacks Authority to Enter an Order Directing that a Soon to Be Chapter 11 Electric Utility Debtor May Not Exercise Rights Under the Code Including the Right to Reject Wholesale Electricity Contracts.

PG&E Corp. v. FERC (In re PG&E Corp.), 2019 WL 2477433 (Bankr. N.D. Cal.2019).
Prepared by Matthew Hamermesh, Esq.

Judge Dennis Montali of the Northern District of California Bankruptcy Court held that, in the Chapter 11 case of a bankrupt electric public utility the Federal Energy Regulatory Commission did not have concurrent jurisdiction to prohibit the debtor from rejecting power purchase agreements with wholesale power distributors.

Prior to the debtor's bankruptcy filing, certain wholesale power distributors obtained an order from FERC — the federal agency that regulates the transmission and wholesale distribution of electricity — stating that PG&E “may not abrogate, amend or reject in a bankruptcy proceeding any rates, terms and conditions of its [PPAs]...without first obtaining approval from {FERC}...” Although FERC stated that it had the power to do this because the power purchase agreements were not just run-of-the-mill contracts but implicate the public interest, the bankruptcy court held that §365(a) applies to all executory contracts. The bankruptcy court further held that it had exclusive jurisdiction over the rejection of contracts in bankruptcy, and enjoined FERC from exercising concurrent jurisdiction and limiting the debtor's ability to reject the PPAs. Rather, the court said they the public interest should be taken into account in determining the standard applicable to considering a motion to reject one of the PPAs.

The court's decision states the baseline that even though a bankruptcy court may take federal regulatory concerns into account in deciding bankruptcy issues, it will not cede those

decisions to federal agencies.

The bankruptcy court also certified the question for direct appeal to the Ninth Circuit Court of Appeals.

Bankruptcy Court that Determines It Does Not Have Subject Matter Jurisdiction Over an Adversary Proceeding May Not Transfer the Adversary Proceedings to Another District.

In re IMMC Corp., 909 F.3d 589 (2018)

Prepared by Derek J. Baker, Esq.

The Third Circuit determined a bankruptcy court does not have authority to transfer an adversary proceeding to another district if the bankruptcy court did not have jurisdiction over the adversary proceeding from the outset.

After confirmation of a Chapter 11 plan, the appointed liquidating trustee commenced an adversary proceeding against certain of the debtor's former directors and officers. In response to an initial motion to dismiss, the bankruptcy court determined that the adversary proceeding was neither "core" nor "related to" the original bankruptcy case (especially in light of the limited jurisdiction post confirmation). Therefore, the bankruptcy court determined that it was without jurisdiction to adjudicate the adversary proceeding. No party appealed the bankruptcy court's determination.

Thereafter, the trustee filed a motion requesting a transfer of the adversary proceeding to nearby district court, asserting that the receiving district court would have appropriate jurisdiction. The bankruptcy court denied the transfer request determining that it was without authority to authorize the transfer under the Judicial Code because it lacked jurisdiction. After an initial appeal to the district court (which affirmed the bankruptcy court's determination), the liquidating trustee appealed to the court of appeals.

The court of appeals began by addressing its prior holdings in the *In re Schaefer Salt Recovery case*, 542 F.3d 90 (3d Cir. 2008). There, the court determined that bankruptcy courts are "units" of the district courts. By that analogy, the trustee argued, and the court implicitly acknowledged - that bankruptcy courts could be transferring courts in accordance with the Judicial Code. The Court however stated that it must first determine if jurisdiction was appropriate in the bankruptcy court. In this instance, the fact that the pending litigation did not have an independent jurisdictional basis in bankruptcy court meant that the bankruptcy court could not appropriately be a transferring court. Here, the bankruptcy court determined that the adversary proceeding was not a matter that could be addressed by the bankruptcy court under the existing reference under the bankruptcy jurisdiction statute (i.e., 28 U.S.C. § 157 and 1334). The Third Circuit concluded that the case was not properly in that court from the outset. Because there was no jurisdiction for the adversary proceeding to be pending in the bankruptcy court under the bankruptcy jurisdiction statute from inception, the bankruptcy court transfer of the adversary proceeding would have been an ultra vires act.

The Court was quick to note that the current decision was not an "all encompassing" decision. It focused specifically on the lack of original jurisdiction in the bankruptcy court as the linchpin for the decision.

Possibility Funds to Pay Attorney Fees Would be Dissipated in the Absence of a Stay Was a Proper Basis under the *Revel* Standard to Stay the Bankruptcy Court's Order Denying a Stay Pending Appeal.

In Re S.S. Body Armor I, Inc., 927 F.3d 763 (3d Cir. 2018).

Prepared by Derek J. Baker, Esq.

The law firm of Carter Ledyard & Milburn (CLM) successfully represented a single shareholder in a challenge to aspects of pre-petition derivative shareholder litigation against Body Amor Inc. After Body Armor filed a chapter 11 case in April of 2010, CLM filed an application for a fee award in the debtor's chapter bankruptcy 11 case. The bankruptcy court recognized that a fee award would be appropriate but did not decide the amount of the award. In addition, the order conditioned the payment of a fee on the debtor actually received funds attributable to CLM's efforts. CLM appealed the bankruptcy court's limitation that the fee had to be paid from funds attributable to CLM's efforts.

While CLM's appeal was pending, a liquidating chapter 11 plan was confirmed in 2015 and eventually \$70 million was paid to trustee of the Recovery Trust created as part of the plan. CLM requested that the bankruptcy court reserve \$25 million of the \$70 million for payment of its fees. The bankruptcy court in its Fee Reserve Order set a reserve of \$5 million. CLM appealed this order. A second appeal was pending.

CLM filed a motion in the bankruptcy court for a stay (enjoin) all distributions from the Recovery Trust until CLM's pending appeal of the Fee Reserve Order setting a \$5 million reserve is completed. The bankruptcy court denied the motion in its Stay Denial Order. CLM filed an appeal (Stay Denial Appeal) in the district court.

Next CLM filed a motion in the district court requesting the district court to enter an order staying all distributions from the Recovery Trust pending resolution of the original Fee Reserve Order which fixed a \$5 million reserve. CLM indicated it was reducing the amount of the requested reserve to \$15 million.

The district court denied CLM's motion for a stay of all distributions from the Recovery Trust pending resolution of the Fee Reserve appeal. The Third Circuit affirmed the district court's denial of the stay after considering whether the district court's order was an appealable final order under 28 U.S.C. §158.

The Court's finality analysis expressed a concern that the practical result of the Court's failure to decide the present appeal now would result in disbursement of all the funds in the Recovery Trust and thereby render the other pending appeals moot. Relying on *In re Revel AC, Inc.*, 802 F.3d 558 (3d Cir. 2015), the Court concluded, that under the flexible approach to bankruptcy appeals the district court's order was an appealable final order because the entire \$70 million in the Recovery Trust could be disbursed before CLM had its day in court to litigate the amount of the fee and receive payment from the trustee. The court concluded, pragmatically, that the failure to hear this appeal could moot all of the other appeals.

Under *Revel*, an appellate court reviewing a denial of a stay should apply four criteria: strong likelihood of success on the merits: irreparable harm absent a stay: lack of substantial injury to other parties for a stay: and support of the public interest. The Court affirmed the rulings by the lower courts a reserve of \$5 million primarily because CLM only asked for \$1.9 million in its original fee application based on hourly rates and a modest multiplier. Since the \$5 million amount to be reserved under the Bankruptcy Court's order was adequate to

protect CLM's fee that in all likelihood would not exceed \$5 million. The \$5 million reserve was well in excess of \$1.9 million or a reasonable multiplier of that amount, and the Court concluded that it was highly unlikely that CLM would succeed in its underlying appeal challenging the adequacy of the \$5 million reserve.

V. CHAPTER 11

On a Motion to Dismiss a §524(g) Asbestos Chapter 11 Case, the Court May Weigh in Favor of Denial of the Motion to Dismiss an Affiliated Company's Agreement to Fund the Debtor's Operating Shortfalls During the Case and to Fund a §524(g) Asbestos Trust.

In re Bestwall, LLC, 2019 WL 3421691 (Bankr. W.D. N.C. 2019).

Prepared by Laurie Krepto, Esq.

A committee of asbestos tort claimants moved for dismissal of the §524(g) chapter 11 case commenced by debtor, Brestwell LLC, (Brestwell) an affiliate of the non-debtor Georgia-Pacific LLC (GP), for bad faith where the debtor that had been formed in 2017 as part of a corporate restructuring under a Texas statute. Brestwell received all of GP's legacy asbestos liabilities and assets (stripped of any untainted assets) and was incorporated in North Carolina 93 days before the filing of the chapter 11 case in North Carolina. The committee asserted the debtor had no real business operations, no employees, and only minimal assets and cash flow other than a funding agreement with GP.

The bankruptcy court denied the motion finding that to dismiss a case for bad faith under Fourth Circuit law, the moving party must establish that the bankruptcy case is both (i) objectively futile; and (ii) subjectively filed in bad faith. This standard is very strict and conflicts with the standards set forth for a bad faith dismissal in other circuits. The court found that the committee had not established the objective futility prong for numerous reasons including a finding that the debtor had the ability to meet its obligations and propose a plan using both its assets and GP's funding agreement. The funding agreement was the key to GP's strategy because it obligated GP to pay as needed cash shortfalls from the debtor's operations and to fund a §524(g) asbestos trust.

Because both prongs were necessary to establish bad faith under Fourth Circuit law, the court did not need to look at whether the case had been subjectively filed in bad faith. The court also denied a request to transfer the case to Delaware.

Intercreditor Agreement Did Not Apply to Adequate Protection Payments Because those Payments Were Not Proceeds of Collateral Nor to Plan Distributions Because the Plan Distributions of Any Type Were Not the Result of the Collateral Agent's Efforts.

Delaware Trust Co. v. Morgan Stanley Capital Group, Inc. (In re Energy Future Holdings Corp), 773 Fed. Appx. 89 (3d Cir. 2019)

Prepared by Derek J. Baker, Esq.

The chapter 11 debtor's 2007 and the 2011 noteholders were secured by the same collateral and bound by an intercreditor agreement. The confirmed chapter 11 plan provided that these noteholders would share the adequate protection payments made during the case and distributions under the plan. The noteholders had a \$90 million difference over how the

payments should be allocated among the 2007 and the 2011 noteholders.

The Collateral Agent for the 2011 noteholders contended that the waterfall provision of the intercreditor agreement governed the allocation among the noteholders and that under the intercreditor agreement the distribution of the realized value of the collateral is to be allocated between the 2017 and 2011 noteholders based on the amount of the notes outstanding at the time of distribution plus accrued interest during the chapter 11 case, not the amount outstanding on the day the chapter 11 case was filed. The date of filing the case versus the date of distribution was significant because the interest on the 2011 notes was materially higher than the interest on the 2007 notes.

The bankruptcy court rejected the Collateral Agent's position and held the intercreditor agreement did not apply to the adequate protection payments or plan distributions. The district court affirmed and the Third Circuit in a non-precedential opinion by Judge Bibas affirmed the district court.

The Court found that the waterfall provision by its terms only applied to payments that are both (a) traceable to a sale or other disposition of the "collateral or proceeds of the collateral" and (b) the collateral agent sold collateral as provided in the security documents. The post-petition adequate protection payments were not traceable to the collateral and even though the plan proceeds of cash, stock, and certain tax benefits might qualify as from the collateral, the distributions were from the debtor not the action by the Collateral Agent.

General Provision of a Plan Was Adequate to Identify Assets Dealt With By the Plan

In re Frontier Ins. Group, 2019 U.S. Dist. LEXIS 43981 (S.D.N.Y. Mar. 18, 2019).
Prepared by Brent C. Diefenderfer, Esq.

The District Court affirmed the bankruptcy court's holding that even though the Debtor's Disclosure Statement did not explicitly identify the Debtor's interests in two parcels of real estate, those parcels were subject to the plan. The Plan defined "Assets" broadly to include "any . . . real property interests" of the Debtor, but the Disclosure Statement identified only the Debtor's "significant assets." The Court opined that it was reasonable to conclude that the Plan covered the interests in two parcels even though they were not specifically listed the Disclosure Statement. The District Court therefore upheld the bankruptcy court's finding that the Debtor's parcels were sufficiently identified during the bankruptcy proceedings because the record included substantial evidence of a mutual understanding between the Debtor and subsidiary that the Debtor was the real owner of those parcels.

Claims Purchased by a Secured Creditor for the Purpose of Preventing the Class of Unsecured Creditors from Voting for a Plan Are Not to be Excluded Under §1126(e) Unless the Party Controlling the Claims Has an Ulterior Motive that Is Other than Being Repaid.

In re Fagerdala USA-Lompoc, Inc., 891 F.3d 848 (9th Cir. 2018)
Prepared by Brent C. Diefenderfer

The Debtor who owned commercial real estate filed a Chapter 11 case and filed an amended plan of reorganization that impaired all classes of claims. Therefore, in order to "cram down" the plan under section 1129(a)(10), the Debtor needed approval of at least one impaired class. Pacific Western Bank, the secured creditor, offered to purchase and did

purchase enough unsecured claims to hold a blocking position of more than one half of the claims in the unsecured class. The Debtor moved to “designate” the votes of the claims purchased by Pacific Western because the claims had not been purchased in good faith. To “designate” means the votes for the claims will not be counted in voting to accept or reject the plan. The Bankruptcy Court concluded that Pacific Western would have an unfair advantage over unsecured claimants who did not receive a purchase offer but who hold the largest percentage of claims by amount.

The District Court affirmed the bankruptcy court. The Ninth Circuit reversed and held that under 11 U.S.C. § 1126(e), a bankruptcy court may not designate claims for bad faith simply because a creditor offers to purchase only a subset of available claims in order to block a plan of reorganization and that blocking the plan will adversely impact the remaining creditors. Bad faith requires more. At a minimum, there must be some evidence that a creditor is seeking “to secure some untoward advantage over other creditors for some ulterior motive.” The Court provided examples of bad faith which included a non-preexisting creditor “purchas[ing] a claim for the purpose of blocking an action against it,” competitors purchasing claims to “destroy the debtor's business in order to further their own,” or a debtor arranging to have an insider purchase claims. The Court concluded that the bankruptcy court erred both by considering the effect on other creditors, without additional evidence of bad faith, and not making actual findings on Pacific Western's motivations. The designation was reversed, and the case was remanded to the bankruptcy court.

A Plan May Provide Additional Compensation to Some of the Claimants of the Same Class If that Compensation Is for Additional Commitments by those Claimants that Contribute to the Debtor’s Effort to Obtain Confirmation of a Plan.

In re Peabody Energy Corp., 2019 WL 3756884 (8th Cir. 2019).
Prepared by Matthew Hamermesh, Esq.

The Eighth Circuit Court of Appeals, in an opinion by Judge Michael Melley, held that a plan that was premised on a private placement offering that offered discounts to qualifying creditors in purchasing preferred reorganization equity did not violate the equally treatment requirement of Section 1123(a)(4), and was proposed in good faith.

An objecting group of creditors argued that allowing qualifying creditors to participate in the rights offering violated the requirement of equal treatment. The court noted that the additional benefits the qualifying creditors received under the plan were not as a result of the treatment of their claims but were on account of valuable new commitments made by those who agreed to participate in the rights offering. The court also noted that the objecting creditors could have received the same benefits by qualifying to participate in the rights offering but chose not to do so. In finding that the debtor proposed the plan in good faith, the court noted that the plan was the result of extensive mediation and was approved by the overwhelming majority of creditors, and the debtor’s board repeatedly gave careful consideration to alternative proposals even after the mediation was concluded. The court also noted that, though it was sympathetic to the complaint the debtor’s solicitation of votes on the plan was somewhat coercive because creditors had to agree to the rights offering before voting occurred, it concluded that did not undermine the debtor’s good faith.

Debtor Satisfies Third Circuit Interpretation of §363 Criteria for Obtaining a Cash Collateral Order.

In re GVM, Inc., et al. (Bankr.M.D.Pa. Sept. 6, 2019)
Prepared by Judge Henry Van Eck

The Debtors filed a motion requesting authorization to use cash collateral that was opposed by secured creditor PeoplesBank (the “Bank”) and unsecured creditor Moneycorp. The Bank objected to the Debtors’ continued use of cash collateral on the grounds that the Debtors had no realistic chance at a successful reorganization, and that permitting the use of cash collateral would only serve to deplete the value of the Bank’s collateral before the Debtors’ inevitable failure. Unsecured creditor Moneycorp also filed an objection on equitable grounds stating that the Debtors’ should be barred from using cash collateral based on the doctrine of unclean hands.

The court divided its analysis into three issues: (1) whether the Debtors attempt to reorganize was clearly futile; (2) whether the Debtors offer of adequate protection was sufficient to protect the bank’s interest during the projected term of use; and, if so (3) whether the motion nevertheless should be denied under the doctrine of “unclean hands.”

The court quickly disposed of the first issue by determining that the evidence and testimony presented by the Debtors, which included reasonable projections based upon unchallenged historical data, was sufficient to show that the businesses could reorganize. In view of this evidence, the court concluded that it would be inappropriate at this stage of the case to conclude that the Debtors had no realistic prospects of reorganization. Likewise, the court promptly rejected the third argument as being an inappropriate use of the equitable powers of § 105(a) in view of the courts determination that the Debtors’ had satisfied the provisions of section §363(c) regarding the use of the cash collateral.

The second issue regarding the Debtors’ offer of adequate protection was the main focus of the court’s analysis. The court identified the three-step process used in determining whether to permit a debtor to use cash collateral as (a) establish the value of the secured creditor’s interest; (b) identify the risk to that value resulting from the debtor’s use of the collateral; and (c) whether the offer for adequate protection offsets that risk.

First, the court independently analyzed the value of the Bank’s interest in the collateral securing its claim for each Debtor based upon the evidence and testimony. The court determined that the value of the collateral securing the Bank’s claim in each case was greater than the amount of its claim in each case. The value of the Bank’s interest that might be entitled to adequate protection was therefore the amount of its claim in each case rather than the value of the collateral securing same. Second, because the collateral in both cases consisted of accounts receivable and proceeds from inventory, the court concluded that the entire value of the Bank’s interest was at risk during the pendency of the case. One of the joint debtors, however, had a significant equity cushion that more than off-set this risk. Because Debtors had each cross-collateralized and guaranteed the debts of the other with regard to the Bank, the equity cushion in the first case was sufficient to off-set the risk to the value of the Bank’s interest in both cases. Finally, the court determined that while this equity cushion alone may have been sufficient to authorize the use of cash collateral, the offer made by the Debtors’ to further ensure adequate protection of the value of the Bank’s interest in the form of replacement liens and weekly interest payments was sufficient to justify the Debtors’ use of cash collateral.

Critical Vendor Motion Denied Because Testimony of Debtor's Officers Did not Support Necessary Factual Predicates to Obtain Relief.

In re GVM, Inc., et al. (Bankr.M.D.Pa. Sept. 6, 2019)

Prepared by Judge Henry Van Eck

In the early stages of this Chapter 11 case, the Debtors sought permission to pay the prepetition claims of vendors identified as critical. In their Motion for Authority to Pay Critical Vendors (the "Motion"), the Debtors submitted that the vendors identified as critical would cease doing business with the Debtors post-petition unless their prepetition claims were paid in full. If the vendors ceased doing business with the Debtors post-petition, they argued, the Debtors' reorganization prospects would be threatened to the detriment of all creditors.

The U.S. Bankruptcy Court for the Middle District of Pennsylvania adopted the two-part test from *In re Kmart Corp.*, 359 F.3d 866, 868 (7th Cir. 2004). In that case, the 7th Circuit concluded that Section 105(a) did not provide the court with authority to authorize the payment of prepetition unsecured debt. The 7th Circuit also concluded that the Section 363(b) likewise offered no support for doing so. Ultimately, the Circuit Court refrained from deciding whether Section 364(b) of the Bankruptcy Code provided the requisite authority to pay certain prepetition unsecured debts outside of a confirmed plan. Instead, the 7th Circuit held that a debtor seeking to pay prepetition claims of critical vendors must prove, not just allege, two things: (1) without the proposed payments on the prepetition claims, the vendors would cease dealing; and (2) the disfavored creditors would be at least no worse off than they would be if the payments are not made.

Here, the President and Owner of both Debtors, as well as their Vice President of Operations, each testified that none of the vendors identified as critical had advised the Debtors that they would cease dealing them post-petition unless their prepetition claims were paid in full. In fact, the testimony indicated that each of the vendors identified as critical had agreed to continue to do business with the Debtors on a post-petition basis, and not to withhold their products or services. Additionally, the Debtors presented no evidence as to the impact of these payments on the creditors who would not receive payment on the prepetition claims. In other words, no evidence was offered to establish that the disfavored creditors would be at least as well off as they would be if the Motion was not granted. The bankruptcy court therefore concluded that the Debtors had failed to carry their burden regarding both elements of the test set forth in *Kmart*. As a result, the Motion was denied.

Like the 7th Circuit, the U.S. Bankruptcy Court for the Middle District of Pennsylvania refrained from deciding if any provision of the Code actually authorizes payment on prepetition claims as requested by Debtors in their Motion. However, the court did note that § 105(a) and § 364(b) provide no independent authority to make such payments.

VI. CLIMATE CHANGE AND CHAPTER 12

Chapter 12 Farm Debtors' Economic Difficulty that Resulted from More than One Poor Growing Season Could Not Be Overcome Even with the Benefit of Chapter 12.

In re Graves Farms, 2019 WL 3407134 (Bankr. D. Kan.2019); First Case, *In re Graves Farms*, 2019 WL 1422891 (Bankr. D. Kan.2019).

Prepared by Laurie Krepto, Esq.

Three generations of the Graves family who found themselves in an ongoing effort to save the family farm sought relief under chapter 12 cases. A plan proposed jointly by the farm partnership (father/son) and individual partners (father/mother; son/wife) in three separate chapter 12 cases could not be confirmed where the plan was based on improper intermingling of debtors' estates, there was insufficient evidence of previous performance to establish the feasibility of the plan, and concerns over plan's change in strategy to add a new crop due to unfavorable weather conditions, a new operator (grandchild/daughter), and new debt. As this was the partnership's second attempt to propose a confirmable plan, the court dismissed the partnership case.

The opinion illustrates the valiant efforts of three generations of the Graves' family facing foreclosure, increasingly hot weather, and flooding to devise creative ways to save the farm that had been in the family for decades.

VII. INVOLUNTARY CASE

Only the Involuntary Debtor Is Entitled Under §303(i) to an Award of Attorney's Fees or Damages on Dismissal of An Involuntary Case.

Matter of 8Speed8, Inc., 921 F.3d 1193 (9th Cir. 2019).

Prepared by Brent C. Diefenderfer

The voting shares of 8Speed8, Inc. were equally divided, and each shareholder had a representative on the board. Sig Capital also had a representative on the board and owned contingent shares. Sig Capital filed an involuntary petition that 8Speed8 did not answer because the two shareholders could not agree on whether to defend against Sig Capital's involuntary petition.

Vibe Micro Inc., one of the 50% owners sought dismissal of the involuntary case. Sig Capital agreed to dismissal and the case was dismissed. The bankruptcy court denied Vibe Micro's request under §303(i) for an award of attorney's fees and damages that would be payable to the debtor 8Speed8. The district court affirmed, and the Ninth Circuit affirmed the district court.

The Court held that only a putative debtor has standing to pursue attorney fees and actual or punitive damages against petitioning creditors following the dismissal of an involuntary bankruptcy cases. Section 303(i)(1) provides that the court may grant judgment "against the petitioners and in favor of the debtor for costs; or reasonable attorney's fees; and subsection (i)(2) continues "or against any petitioner that filed the petition in bad faith for any damages proximately caused by such filing or punitive damages"(emphasis added)." The Court read the limitation "in favor of the debtor in (i)(1) to also apply to an (i)(2) damage

award.

The Court reasoned that §303(i) is intended to alleviate the consequences that involuntary proceedings impose on the debtor. Those consequences include loss of credit standing, inability to transfer assets and carry on business affairs, and public embarrassment. The Court concluded that a third party, who intervenes freely in an involuntary action, does not face those same consequences. Even if it did, § 303(i) would still not guarantee costs, fees, or damages. An award under § 303(i) —which states that the court “may” award costs, fees, or damages—is not mandatory.

Judge Bennett dissented on the ground that the majority’s interpretation was not obvious from the text and that when there is corporate deadlock it is necessary to permit awards to the debtor to sought by interested parties in order to insure there is some deterrence to precipitous filing of an involuntary petition.

VIII. CLAIMS

Default Interest Is Presumptively Valid in California and the Default Rate Was Reasonably Related to the Lender’s Potential Loss on Default.

E. W. Bank v. Altadena Lincoln Crossing, LLC, 598 B.R. 633 (C.D. Cal. 2019).

Prepared by Brent C, Diefenderfer

The debtor obtained two construction loans from E.W. Bank (Lender) containing a 5% default interest rate. When the Debtor failed to repay the larger loan at the original maturity date, the Debtor entered into a number of modification agreements with lender which increased the principle loan amount, and which extended the maturity date. The parties over the next 8 years entered into a series of short-term forbearance agreements that mostly served to extend the maturity date. On maturity of the loan in April of 2017, the debtor filed for bankruptcy.

The Debtor objected to the accrual of default interest in the lender’s proof of claim. The Bankruptcy Court disallowed the lender’s claim for default interest and Lender appealed. The Bankruptcy Court first noted that contractual default interest rates should be enforced in bankruptcy, unless the default interest provision is not enforceable under California law because the default rate was an unenforceable penalty. The Bankruptcy Court determined that “the default interest provisions in the loan agreements did not have a reasonable relationship to the range of actual damages that the parties could have anticipated would flow from a breach at the time the contracts were made” and was an unenforceable penalty.

The District Court reversed the Bankruptcy Court after conducting a careful review of the applicable California statutes and common law and finding that the default interest rate provision was valid and enforceable primarily because on a borrower's default, the value of the loan in the secondary market, viewed as a bank asset, decreases. The District Court recognized that the default interest rate was reasonably related to the reduction in value of the bank's asset and was a measurable economic damage that occurs as the result of default.

Attorney Fees Arising Post-Petition under a Pre-Petition Contract Are Unsecured Claims Because Nothing in the Code Expressly Bars Such a Claim.

SummitBridge National Investments III, LLC v. Faison, 915 F.3d 288 (4th Cir.).

Prepared by Lisa Rynard, Esq.

The confirmed Chapter 11 Plan reserved the right of SummitBridge to file an unsecured claim for post-petition attorney fees incurred defending its secured proof of claims. Upon the filing of SummitBridge's unsecured claim, Debtor, Faison, objected on two grounds: a) a state law noticing provision; and b) that the Bankruptcy Code does not allow an unsecured claim for post-petition attorney fees. The Bankruptcy Court, addressing only the federal law question, agreed with the Debtor that the Bankruptcy Code does not allow SummitBridge to assert an unsecured claim for post-petition attorney's fees. On appeal, the District Court affirmed.

Does the Bankruptcy Code bar a creditor from asserting an unsecured claim for attorney's fees, if those fees are incurred after the filing of a bankruptcy petition but under an enforceable provision of a pre-petition contract? The Fourth Circuit in an opinion by Judge Harris holds that under *Travelers Casualty & Surety Co. of America v Pacific Gas & Electric Co.* 127 S.Ct. 1199 (2007) the answer is that post-petition attorney fees arising out of pre-petition note are proper unsecured claims because the Code does specifically provide otherwise

The Fourth Circuit joins the First, Second, Ninth, and Eleventh Circuits, that have all unanimously ruled, post-*Travelers*, allowing unsecured claims for contractual attorney fees that accrued post-filing of the bankruptcy petition. This issue is presently before the Third Circuit, in *In re Tribune Media Co.*, Docket No. 18-3793.

Court Approves Default Rate of 7% Above the Indexed Mortgage Rate Because Debtor Did Not Overcome the Presumption that a Default Rate Applies Absent a Showing of Equitable Considerations by the Debtor.

In re 1111 Myrtle Avenue Group, LLC, 598 B.R. 729 (Bankr. S.D.N.Y.)

Prepared by Lisa Rynard Esq.

As contemplated in the confirmed Chapter 11 Plan, Preferred Bank, a Lender filed a Motion to Allow Payment of Default Interest and Legal Fees under §506(b) of the Bankruptcy Code. The Debtor opposed the Motion. The Bankruptcy Court applied the presumption that the contract rate of interest, including any increased rate in the event of a default, is enforceable in bankruptcy unless the debtor rebuts the presumption and concluded that the Lender was entitled to collect interest at a default rate of 7% above the basic loan rate.

Previous cases have permitted default interest after consideration of the following equitable factors: lender misconduct; harm to unsecured creditors; and the debtor's fresh start would be impaired. The Myrtle Court assessed these equitable considerations in the context of a chapter 11 plan of a solvent debtor that paid unsecured creditors were paid 100% and, therefore, the presumption for enforcing the default interest rate had not been rebutted.

Yield Maintenance Premiums Triggered by Any Default Are Generally Enforceable Under New York Law.

In re 1141 Realty Owner LLC, 598 B.R. 534 (Bankr. S.D.N.Y. 2019)
Prepared by Brent C. Diefenderfer

Debtor's recently acquired hotel business failed quickly, and a chapter 11 case was filed. The Debtor objected to the proof of claim filed by mortgage lender for payment of a prepayment penalty. Lender moved for summary judgment. Under the loan documents, prepayment of the loan was not permitted and if the Debtor prepaid any portion of the principal of the loan, the Debtor was required to pay a "Yield Maintenance Default Premium" ("the Premium"). Pre-petition, the Debtor defaulted on the promissory notes and Lender accelerated the debt and demanded immediate repayment in full. The proof of claim contained the Premium in the approximate sum of \$ 3.1 million. The Court allowed the claim finding that the Premium was an enforceable liquidated damages clause reasoning that the documents provided that any payment following an Event of Default was deemed a "voluntary prepayment" which required the payment of the Premium. The loan documents entitled lender to recovery of the Premium in connection with any *payment* made after an event of default, not just Residentsa *prepayment* made after an event of default.

IX. APPLICATION OF AVOIDING POWER OUTSIDE UNITED STATES

Transfers by the Debtor that Are Originated in the United States for Delivery to a Transferee in a Foreign Country Are Domestic Transfers that May Be Avoided Under §550 Whether the Transferee is an Initial Transferee or a Subsequent Transferee.

In re Picard, Tr. for Liquidation of Bernard L. Madoff Inv. Sec. LLC, 917 F.3d 85 (2d Cir. 2019).
Prepared by Matthew Hamermesh, Esq.

Foreign feeder funds invested billions of dollars for their local investor clients with the Madoff firm and received back from Madoff money withdrawn by those local clients. The withdrawn money was deposited to an account for or delivered to the local client. The Madoff Trustee brought fraudulent transfer actions against these local clients who are referred to as subsequent transferees.

The bankruptcy court dismissed the actions on remand from the district court that had found that the trustee's avoiding powers did not extend beyond the territory of the United States and were barred by considerations of international comity. The Second Circuit reversed in an opinion by Judge Richard Wesley. It first held that although there is a canon of statutory construction against extraterritorial application of statutes, it did not apply to the combination of §§548 and 550 because the initial transfer to the feeder fund is a domestic activity that does not implicate the presumption against extraterritorial application of American law. The transferee's location when the transfer is received is not the focus of sections 548 and 550. The Court also held that international comity principles did not bar pursuit of the fraudulent transfer claims against the subsequent transferee investors, even though that might create a conflict with the pursuit of similar claims by the trustees of the initial transferee feeder funds in foreign liquidations.

Chapter Three

Consumer Protection Litigation

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RECENT DEVELOPMENTS IN CFPB REGULATIONS

SCOPE:

- 1. Successor in Interest**
- 2. “Delinquency” Definition**
- 3. Requests for Information**
- 4. Forced Placed Insurance**
- 5. Early Intervention**
- 6. Loss Mitigation**
- 7. Prompt Payment Crediting**
- 8. Periodic Statements**
- 9. Small Servicers**

SUCCESSOR IN INTEREST:

Previously, Successors in Interest (“SII’s”) experienced difficulty in getting information from servicers as to loan status, monthly payment amounts, options to avoiding foreclosure, etc....

Regulations X - RESPA & Z - TILA updated the definition effective 1/10/14

‘Borrower/Consumer’ now specifically includes SII

A. WHO IS A SII

The definition was expanded beyond deceased borrowers. It hinges on how the ownership interest was obtained by the party in question.

- **Death of a joint tenant**
- **Transfer to a relative resulting from the death of a borrower**
- **Transfer to a spouse or children**
- **Transfer to a spouse as a result of divorce or legal separation**
- **Transfer to an inter vivos trust - borrower remains a beneficiary and there is no transfer of occupancy rights.**
- **Assumption of the mortgage loan/liability thereon is NOT required**

B. HOW TO VERIFY

- **A servicer must respond to a written request from a potential SII if SII gives borrower name AND provides sufficient information for servicer to identify the loan**
- **The written response must include a description of the documents needed to confirm identity and ownership interest as well as contact information for further assistance**

DELINQUENCY - THE DEFINITION HAS CHANGED

- **Previously, when a loan became delinquent was somewhat ambiguous and there was no delinquency end date.**
- **Under 2016 CFPB Final Rules, delinquency starts on the date where a periodic payment is due and is unpaid. It ends on the date where no periodic payment is due and unpaid**

REQUESTS FOR OWNERSHIP INFORMATION

- **Loans in Trust - FNMA/FHLMC = Owner**
- **New response requirements for loan ownership information**

FORCED PLACED INSURANCE

- **Disclosures/Model Forms have been revised**
- **Now addresses insufficient coverage vs. expired/expiring coverage**
- **Acceptable to include account number on FPI notice**

EARLY INTERVENTION

A. Clarifies obligations for servicers regarding live contact and written notice

- **Servicers must make a good faith effort during delinquency to make live contact with a borrower**
- **Servicers are required to send a written notice 1 time during a 180 day period**

B. Revises exemptions to live contact

- **No requirement if a borrower is in bankruptcy or if borrower has invoked cease communication protection under FDCPA**

C. Exemptions to written notice requirement

- **Is there a loss mitigation option available**
- **Is borrower in bankruptcy and/or have they invoked their cease communication protection under FDCPA**

LOSS MITIGATION

A. Loss Mitigation may be an option more than once during the life of a loan if a borrower becomes current

B. Servicer Requirements -

- **5 day acknowledgement of complete application**
- **If an incomplete application is submitted, a short term repayment agreement may be offered**

- **Servicer must use reasonable diligence with regard to 3rd party information**
- **If there is a service transfer, the new servicer is bound by old timeframes**
- **Must communicate dates by which borrower needs to return documents or submit information in order to complete loss mitigation**
- **Servicer may stop review if they become aware that the borrower is ineligible**

PROMPT PAYMENT CREDITING

- A. During a Trial Modification servicers may credit the payments made under the terms of the loan documents which may result in a credit as a partial payment**
- B. Once it becomes a Permanent Modification, payments must be credited under the terms of the Permanent Modification.**

PERIODIC STATEMENTS

- A. Disclosure requirements are established and they must include the amount due**
- B. If a loan is accelerated but the servicer will accept a lesser amount - reinstatement - the lesser amount has to be on the periodic statement rather than the accelerated amount**
 - **Borrower is considered to be more likely to pay the reinstatement amount, thus avoiding foreclosure**
 - **Putting the full accelerated amount on the statement may cause confusion**
 - **If there is a Permanent Modification, the periodic statement must show the amounts due under the modification**
 - **If there is a Temporary/Trial Modification, the periodic statement may disclose either the payment due under the**

Temporary/Trial Modification or the amount due under the original contract terms

C. Special considerations for loans in Bankruptcy

- **Previously, servicers were exempt from sending periodic statements for any loans in bankruptcy or that had been discharged**
- **April 19, 2018 - requirements changed and servicers now required to send periodic statements in many instances**
- **There is still an exemption from sending periodic statements for loans that are in BK if a 2 prong test is met -**
 1. **Any borrower on the loan is a debtor or has been discharged AND**
 2. **Borrower sends a cease letter regarding periodic statements OR**
 3. **Plan provides for surrender of the property in question, avoidance of the lien, or other indication that the borrower is not attempting to cure the default/retain the property**
- **If plan surrenders and borrower then starts making payments, servicer may be required to resume sending periodic statements**
- **If a loan is charged off, no requirement to send a periodic statement so long as servicer is not assessing any additional fees or interest and servicer must send a Final Periodic Statement**
 1. **Suspension of Statement and Notice of Charge Off - Retain this copy for your records**
 2. **Additional disclosures required**

SMALL SERVICERS

- A. Many of the CFPB regulations do not apply to Small Servicers**

- B. Small Servicers previously defined as a servicer who services 5000 or fewer mortgage loans, and only loans they, or an affiliate, originated**
- C. New definition excludes certain seller-financed transactions and mortgage loans from a non-affiliate may not be counted toward the 5000 loan limit in some instances**

Avoidance Actions & Bankruptcy Alternatives

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The outlines in this chapter were created from the PowerPoint slides used by the presenters.

Chapter Four
Section 1

Interesting Issues Regarding Avoidance Actions

Interesting Issues Regarding Avoidance Actions

I. Federal Rule of Bankruptcy Procedure 7068 (incorporating Federal Rule of Civil Procedure 68)

(a) Making an Offer; Judgment on an Accepted Offer. At least 14 days before the date set for trial, a party defending against a claim may serve on an opposing party an offer to allow judgment on specified terms, with the costs then accrued. If, within 14 days after being served, the opposing party serves written notice accepting the offer, either party may then file the offer and notice of acceptance, plus proof of service. The clerk must then enter judgment.

(b) Unaccepted Offer. An unaccepted offer is considered withdrawn, but it does not preclude a later offer. Evidence of an unaccepted offer is not admissible except in a proceeding to determine costs.

(c) Offer After Liability is Determined. When one party's liability to another has been determined but the extent of liability remains to be determined by further proceedings, the party held liable may make an offer of judgment. It must be served within a reasonable time—but at least 14 days—before the date set for a hearing to determine the extent of liability.

(d) Paying Costs After an Unaccepted Offer. If the judgment that the offeree finally obtains is not more favorable than the unaccepted offer, the offeree must pay the costs incurred after the offer was made.

Rule 7068 only applies to adversary proceedings, not contested matters.

II. What Costs Are Included?

- “Costs” under Rule 68 include only costs allowed under Federal Rule of Civil Procedure 54 and 28 U.S.C. section 1920.
- “Costs” include filing and appearance fees, service of process fees, court reporter fees, needed deposition transcripts, per diems for witness and expert witness, compensation of interpreters, copying and collating exhibits and graphics for trial, and costs of hiring computer technicians to assist in the e-discovery process.

III. Are Attorneys’ Fees Considered Costs?

- Attorneys’ fees are considered costs under Rule 68 in certain circumstances. Specifically, fees are recoverable as costs where a specific statute includes attorneys’ fees in its definition of costs. In addition, the United States Supreme Court has held that attorneys’ fees are recoverable as costs under The Civil Rights Attorney’s Fees Awards Act of 1976. The Eleventh Circuit has held that fees are recoverable as costs under The Copyright Act.
- While it may be unlikely that fees would be recoverable as costs in the bankruptcy context, it is something to keep in mind.

IV. Can a Chapter 7 Debtor Attorney Then Represent An Avoidance Action Defendant?

- In a recent decision, the bankruptcy court for the Northern District of Illinois held that a former counsel for a debtor can represent preference defendants. Peterson v. Sanches (In re Mack Indus., LTD) (Bankr. N.D. Ill. Aug. 14, 2019)
- The Chapter 7 Trustee had filed motions to disqualify counsel, arguing that counsel owed a duty of loyalty and statutory duty to the bankruptcy estate, and, therefore, could not now oppose the trustee or estate by representing preference defendants. Trustee also argued that representation is prohibited under rules of professional conduct.
- Court found that attorney did not owe any duty to the estate; rather the duties were owed to the debtors, and once counsel withdrew from representation of debtors, he is clear to represent preference defendants.
- Court also found that this representation did not violate rules of professional conduct.

V. Changes

- Under the Small Business Reorganization Act of 2019, certain changes were made to the Bankruptcy Code regarding preference actions.
- Preferences.—Section 547(b) of title 11, United States Code, is amended by inserting “, based on reasonable due diligence in the circumstances of the case and taking into account a party’s known or reasonably knowable affirmative defenses under subsection (c),” after “may”.
- How does this square with section 547(g), which requires a defendant to prove affirmative defenses?
- Venue of certain proceedings.—Section 1409(b) of title 28, United States Code, is amended by striking “\$10,000” and inserting “\$25,000”. So, now preferences must be brought in the district in which the defendant resides if the demand is under \$25,000.

VI. Preferences Against Insider Guarantors

- Insiders who guaranty a debtor’s obligation are subject to preference liability under Section 547(b) of the Bankruptcy Code where the debtor pays down the guaranteed debt within one year prior to the bankruptcy filing.
- A guarantor benefits from such a pay down of the debt, albeit indirectly, by the reduction of its contingent liability to the lender.
- The preference elements still must be met with respect to the transfer that paid down the guaranteed debt, that: the Guarantor is an insider, as defined under Section 101 of the Bankruptcy Code; the transfer, which paid down the debt, occurred within one year before the bankruptcy filing; the transfer was a transfer of debtor property; the transfer was made for the benefit of the guarantor by reducing the contingent liability; the transfer was made for or on account of antecedent debt; the transfer was made while the debtor was insolvent; and the transfer enabled the guarantor to receive more than it would receive if: (i) the debtor’s bankruptcy case was a case under chapter 7 of

the Bankruptcy Code; (ii) the transfer had not been made; and (iii) the guarantor received payment to the extent provided by the provisions of the Bankruptcy Code.

❖ Practice Pointers for Parties Impacted

- Pursuant to Section 550(c)(2) of the Bankruptcy Code, a non-insider creditor/lender who receives a payment outside of the 90-day preference period may not be sued for a preference, even where a guarantor may be sued.
- A careful guarantor may eliminate its exposure by contracting away its subrogation rights when the guaranty is entered (in essence, agreeing not to step into the shoes of the debtor or seek a claim against the debtor to the extent the guarantor is required to pay down the debt).
- Creditors' Committees, Liquidating Trustees and Chapter 7 Trustees should investigate and pursue claims where insider guarantor exposure was reduced by payments made by the debtor to a lender within one year of the bankruptcy filing. Debtors will often fail to highlight this source of recovery.

Chapter Four
Section 2

Avoidance and Recovery of Constructively Fraudulent Transfers: 11 U.S.C. § 548(b)

Avoidance and Recovery of Constructively Fraudulent Transfers

11 U.S.C. § 548(b)

I. Section 548 of the Bankruptcy Code:

A transfer of property is deemed constructively fraudulent under 11 U.S.C. § 548(a)(1)(B) if, within two years prior to the filing of the Petition in Bankruptcy, the transferor receives “less than reasonably equivalent value” in a transaction and (1) the transferor was insolvent at the time of the transfer or rendered insolvent as a result of the transfer, or (2) the transferor was undercapitalized at the time of the transfer or became undercapitalized as a result of the transfer, or (3) the transferor was unable, or rendered unable by the transfer, to pay its debts as they became due. See In re Zambrano Corp., 470 B.R. 670, 698 (Bankr. W.D.Pa. 2012)

II. Burden of Proof:

- (“The Trustee has the burden of proving each of these requirements by a preponderance of the evidence. Pension Transfer Corp. v. Beneficiaries (In re Freuhauf Trailer Corp.), 444 F.3d 203, 211 (3d Cir.2006).
- To prevail, the Trustee must demonstrate that: (1) debtor had an interest in property; (2) the interest was transferred within two years of the petition date; (3) debtor was insolvent when the transfer occurred or was made insolvent as a result of the transfer; and (4) debtor received “less than a reasonably equivalent value in exchange for such transfer”. Mellon Bank v. Official Committee of Unsecured Creditors of RML, Inc. (In re RML, Inc.), 92 F.3d 139, 144 (3d Cir.1996)).

III. What Constitutes Reasonably Equivalent Value:

- “Reasonably equivalent value” is not defined or explained in the Bankruptcy Code.
- Determining “reasonably equivalent value” has been viewed as a two-step process in which the court first determines if the debtor received value, and second, whether the value received by the debtor was reasonably equivalent to the value the debtor gave up. In re Eckert, 388 B.R. 813, 831 (Bankr. N.D. Ill. 2008).
- “Reasonably equivalent value requires a comparison of the value of what went out with the value of what came in.” In re Southmark Corp., 138 B.R. 820, 829 (Bankr. N.D.Tex. 1992).
- “The focus is on the consideration received by the debtor, not on the value given by the transferee”, because the lack of consideration received is what harms creditors of the Debtor. In re Jeffrey Bigelow Design Group, Inc., 956 F.2d 479, 484 (4th Cir. 1992).

IV. Direct versus Indirect Benefit:

- Indirect benefits may include such things as an extension of credit and ability to borrow funds. See In re Mellon Bank v. Metro Comm. Inc., 945 F.2d 635, 645 (3d Cir. 1991).
- “Generally, a court will not recognize an indirect benefit unless it is ‘fairly concrete’.” Leibowitz v. Parkway Bank & Tr. Co. (In re Image Worldwide), 139 F.3d 574, 578 (7th Cir. 1998)

V. Insolvency

- Must also prove that the debtor was insolvent
- A debtor is deemed insolvent:
 - if the sum of the debtor’s debt is greater than the sum of all the debtor’s assets at a fair valuation. 11 U.S.C. § 101(32)(A);
 - it is unable to satisfy its obligations as they become due; or
 - the *debtor’s* remaining assets are unreasonably small in relation to the transaction.
- Only need to demonstrate insolvency under one of the three tests, although passing one may impact conclusions under another. See Blixseth v. Kirschner (In re Yellowstone Mt. Club, LLC), 436 B.R. 598, 667 (Bankr. D. Mont. 2010); Astarte, Inc. v. Pacific Indus. Sys., 865 F. Supp. 693, 702 (D. Colo. 1994)(“The test for insolvency is thus a disjunctive test, with any of three criteria being sufficient.”).

VI. Defenses to Section 548(b)

- 11 U.S.C. § 548(c) provides a defense to a constructively fraudulent transfer where the transferee or obligee of such a transfer or obligation takes for value and in good faith, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.
- 11 U.S.C. § 548(c) is “an affirmative defense, and therefore the burden is on the defendant-transferee to plead and establish facts to prove the defense.” SB Liquidation Trust v. Preferred Bank (In re Syntax-Brilliant Corp.), 2016 Bankr. LEXIS 988 * 9 (Bankr. D. Del.); see also, Zazzali v. AFA Fin. Group, LLC, 2012 Bankr. LEXIS 4045 * 2-3 (Bankr. D. Del.)(“[T]he good faith/value defense ... is an affirmative defense and is not part of [the] prima facie case under § 548(a)(a)(A).”); Roeder v. Lockwood (In re Lockwood Auto Group, Inc.), 450 B.R. 557, 574 (Bankr. W.D.Pa. 2011)(“The concept of good faith on the part of a transferee in a fraudulent transfer action is found as part of the affirmative defenses set forth in Section 548(c”).

VII. War Story/Hypothetical...

- Principal of the debtor sought financing for a separate entity in which he had an interest
- Could not obtain financing directly for the separate entity
- The debtor was used to obtain financing

- Liens given against real estate owned by the debtor
- Monies received were immediately transferred out to the other entity
- The debtor did not receive the benefit of the monies received
- Defendant asserted that the debtor received the funds, so value received
- Defendant asserted the debtor was solvent on a balance sheet basis as the value of the real property exceeded its debts
- Debtor was unable to pay debts as they came due
- Debtor's available assets were small as the debtor's assets were illiquid

VIII. Court holding...

- Trustee met burden of proving that the debtor did not receive reasonably equivalent value in exchange for the transfers
- Monies went out to the other entity with no direct and/or indirect benefit to the debtor
- Court found that while the debtor was solvent on a balance sheet basis, it was insolvent under the other two tests, and thus insolvent for the purposes of 11 U.S.C. § 548(b)
- The Court avoided the initial transfer, as well as, subsequent payments made to the Defendant as fraudulent transfers

Chapter Four
Section 3

Avoidance and Recovery of Post-Petition Transfers: 11 U.S.C. § 549

Avoidance and Recovery of Post-Petition Transfers

11 U.S.C. § 549

I. Section 549 of the Bankruptcy Code provides,

“the trustee may avoid a transfer of property of the estate... that occurs after the commencement of the case...and that is not authorized under this title or by the court.”

II. Property of the Estate

11 U.S.C. § 541(a):

- The commencement of a case . . . creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held: . . .all legal or equitable interests of the debtor in property as of the commencement of the case.

III. Defenses to Section 549

- Property transferred was not property of the estate
- Property transferred was exempt
- Property was restricted for certain use (“Earmark Doctrine”)
- Transfer did not occur post-petition
- Transfer was authorized by the Code and/or Court

IV. War Story/Hypothetical...

- Debtor requested hardship withdrawal from retirement plan pre-petition
- Request was approved and Debtor was sent a check
- Check was delivered to Debtor’s residence hours before petition filed
- The Debtor provided the check to her attorney, who deposited and then paid the proceeds to Debtor’s mortgage holder (post-petition)
- Debtor did not disclose check or claim an exemption in the check
- Retirement plan was disclosed, and exemption claimed

V. Was check property of the estate?

- *Marchand v. Whittick (In re Whittick)*, 547 B.R. 628 (N.J. Bankr. 2016)
- Debtor’s prepetition future interest in PERS loan became property of the estate pursuant to section 541(a)(1)
- Proceeds became property of the estate pursuant to section 541(a)(6) upon receipt of the funds post petition

- “[I]f a Chapter 7 debtor has a contingent right to receive funds in the future, that contingent right belongs to the bankruptcy estate and if the contingency occurs post petition, the funds received belong to the Chapter 7 Trustee[.]”

VI. Was check exempt?

- *In re Hipple*, 225 B.R. 808, 813, (N.D. Ga. 1996)
- Court sustained objection to Debtor’s exemption in SEP/IRA account
- “[t]he disbursement of SEP/IRA funds to Debtor, the beneficiary of the account, resulted in a withdrawal of those funds from the trust. Upon withdrawal, those funds ceased to be SEP/IRA funds.”)

VII. Were funds earmarked?

- The Third Circuit requirements to establish earmarking:
- (1) the existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt,
- (2) performance of that agreement according to its terms, and
- (3) the transaction viewed as a whole ... does not result in any diminution of the [debtor's] estate.

VIII. Burden of Proof for Earmarking

- Trustee has burden of proving that the transfer is avoidable under section 549(a)
- Burden then shifts to transferee to prove that funds in question satisfy the three elements of the earmarking doctrine

IX. Court holding...

- Trustee met burden of proving that funds were property of the estate - funds were withdrawn from the retirement account pre-petition
- (no dispute as to timing of payment or whether it was authorized by the Code or the Court)
- First element of earmarking doctrine cannot be met, no new lender exists
- Source of funds in question came from the Debtor’s own retirement account
- Earmarking must be narrowly construed
- Funds were not exempt – were not in account when petition was filed

❖ Discussion...

- Have you been able to utilize the earmarking defense successfully?
- Would the outcome change if the Debtor tore up the check pre-petition?
- Would the outcome change if the Debtor tore up the check post-petition?
- What if the Debtor retained the check in her possession?

Chapter Five

Chapter 11 Primer

Chapter Five
Section 1

If Chapter 13 Doesn't Work, How about Chapter 11?

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Why File a Chapter 11 (11 U.S.C. §109(d))

The Advantages

- A) No debt limit (Chptr 13 - \$394,725.00 uns & \$1,184,200.00 scd);
- B) Cram down of real property;
- C) Cram down of personal property;
- D) Partial discharge of unsecured claims

The Disadvantages

- A) Cost (compared to Chptr 13);
- B) Time to confirm plan (compared to Chptr 13);
- C) Absolute Priority Rule;
- D) Oversight by Office of the U.S. Trustee,
Operating Reports, Quarterly Fees;
- E) paying disposable income for five (5) years - § 1129(a)(15)

The initial consultation

- A) What caused the current financial situation?
- B) How can the problem be resolved?
- C) Understanding the bankruptcy estate:
Assets, Liabilities, Exemptions (§ 703 & 704)
- D) What are your bankruptcy goals
 - 1) Keep real property and cars;
 - 2) Partial discharge of unsecured claims;
 - 3) Stop spending retirement
- E) Does any other Chapter make sense?
 - 1) Not Chptr 7 – cannot reorganize properties;
 - 2) Not Chptr 13 – do not qualify (§ 109(e))

1st Plan (at the beginning)

- A) Identifying Claims
 - 1) Unclassified
 - a) Administrative (i.e., Professionals);
 - b) Quarterly Fees/Clerk's Fees;
 - c) Priority Claims (such as income taxes)
 - 2) Classified
 - a) Secured
 - i) what is the collateral
 - real property
 - personal property
 - ii) strategies to protect the collateral
 - is the security interest properly documented;
 - is the security interest perfected;
 - has the default been documented properly.
 - iii) guarding against potential preference exposure
 - analyze payment history;
 - timing of perfecting security interest;
 - delaying bankruptcy filing
 - iv) negotiate payment plan outside of bankruptcy
 - b) Unsecured priority
 - c) Unsecured Non-priority
- B) How will you fund the Plan
 - 1) income/expenses
 - 2) selling assets;
 - 3) contributions from others

Filing the Petition

- A) Necessary Documents
 - 1) Filing Fee;
 - 2) Petition/Schedules/SFA/List of 20 largest unsecured creditors/Credit Counseling Certificate/Chapter 11 Statement of Current Monthly Income/Attorney Disclosure/Stmt of SSN
- B) First Day Motions
 - 1) Employ Counsel and other professionals;
 - 2) Cash collateral;
 - 3) Insider Compensation.

- C) Initial Operations
 - 1) Open DIP accounts and estate t/p ID number;
 - 2) Operating & Reporting requirements
 - 3) proof of insurance
 - 4) last 2 yrs tax returns and pay stubs
 - 5) Deeds and mortgage statements;

- D) U.S. Trustee
 - 1) Initial Debtor Interview (rvw of Ptn & Sch);
 - 2) Meeting of Creditors (ID, testimony under oath, and rvw Sch);
 - 3) Quarterly Fees

- E) Implementing bankruptcy
 - 1) Employment application (conflict of interest, fees paid, fees anticipated);
 - 2) collecting revenue and paying expenses
 - 3) Monthly Operating Reports;
 - 4) Court's status hearing;
 - 5) Motion for proof of claim deadlines;
 - 6) Filing Plan & Disclosure Statement

Confirmation

- A) Chapter 11 Plan
 - 1) Debtor's Plan or 3rd Party Plan
 - 2) Classification, Treatment, and Duration;

- B) Motion for Approval
 - 1) Classification and Treatment issues; unclassified claims (administrative expenses, statutory fees, and priority taxes)
 - 2) classified claims (secured, priority, non-priority, and equity)
 - a) Feasibility Issues
 - i) projections of future income;
 - ii) discrimination;
 - iii) fair & equitable;
 - iv) lien retention
 - b) Absolute Priority Rule (*See, In re Brown* , 498 B.R. 486, 507 (Bankrcty.E.D.Pa. 2013), *aff'd, Brown v. Ferroni*, 505 B.R. 638, 649-50 (E.D.Pa. 2014))
 - i) The equity interest holders (here Mr. and Mrs. Debtor) cannot retain *any* (non-exempt) pre-petition property unless the class of unsecured creditors vote to accept the Plan or are paid *in full* under the Plan
 - ii) exception - §1129(b)(2)(B)(ii)

- 3) Voting creditors [(1126(c))
 - a) voting - 2/3 in amount of allowed claims and 1/2 in number of allowed claims per class;
 - b) cram down
 - i) all 16 applicable plan confirmation requirements of §1129(a) are met;
 - ii) pursuant to § 1129(b)(2), the plan does not “discriminate unfairly” and is “fair and equitable”

Post Confirmation

- A) Confirming Plan
- B) Determining value of liens
- C) Objecting to claims
- D) Post confirmation quarterly reports and fees
- E) Final fee applications
- F) Motion for Discharge
 - 1) after completion of all payments - § 1141(d)(5)(A)
 - 2) before payment completion - § 1141(d)(5)(B)

Chapter Five
Section 2

Smaller Chapter 11s and Closely-Held Businesses

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The Small Business Chapter 11: Outline

I. THE “SMALL BUSINESS” DESIGNATION

GENERAL PROVISIONS IN A SMALL BUSINESS CASE

A “small business case” is a chapter 11 in which the individual or business has “aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition ... of not more than \$2,490,925.” 11 U.S.C. §101(51)(D). A committee of creditors will not be appointed in a small business case. *Id.*; 11 U.S.C. §1102(a)(1),(3). The case will proceed as a small business case unless and until the Court enters an Order finding the debtor’s statement to be incorrect. *Id.*

In order for a case to be designated a “small business case,” the debtor must state in the petition that the debtor is a small business debtor. Fed.R.Bankr.P. 1020(a).

As a result of the fact that no committee is appointed, the United States Trustee will have greater oversight over a small business chapter 11. The trustee will conduct an initial debtor interview prior to the 341 meeting of creditors to determine the debtor’s likely ability to be successful in a chapter 11.

FILING REQUIREMENTS

In addition to the requirements of any chapter 11 debtor, a small business debtor is required to provide, at the time the completed petition is filed:

1. Most recent balance sheet;
2. Statement of operations;
3. Cash-Flow Statement;
4. Federal Income Tax Return; or
5. Statement under penalty of perjury that no balance sheet, statement of operations or cash-flow statement has been prepared and/or no Federal tax return has been filed.

11 U.S.C. §1116.

REPORTING REQUIREMENTS

A debtor in a small business case must file monthly financial reports, using Form, 25C which include:

1. The debtor’s profitability;¹
2. The reasonable approximations of the debtor’s projected cash receipts and cash disbursements over a reasonable period;
3. Comparisons of actual cash receipts and disbursements with projections in prior reports;
4. Whether the debtor is in compliance with all post-petition requirements imposed by the Code and Bankruptcy Rules (i.e., insurance, taxes, etc. as in any chapter 11 case) or, if not in compliance, what the failures are and how the debtor intends to remedy such failures.

¹ “Profitability” means the amount of money that the debtor has earned or lost during current and recent fiscal periods. 11 U.S.C. §308.

11 U.S.C §308(a)-(b); Fed.R.Bankr.P. 2015(a)(6).

PLAN AND EXCLUSIVITY PERIODS

In a small business case, the exclusivity period for filing a plan is one hundred eighty (180) days. A plan must be filed within three hundred (300) days. The exclusivity period for a debtor to file a plan may only be extended for cause, and the debtor bears the burden of establishing cause. In any case, a plan must be filed within 300 days, unless the debtor can establish by a preponderance of the evidence that a confirmable plan can be confirmed within a “reasonable” time. 11 U.S.C. §1121(e). A significant difference is that an order on a request for an extension of time for filing a plan must be signed before the existing deadline has expired. *Id.*

DISCLOSURE STATEMENT AND PLAN SOLITICATION

The Court may waive the Disclosure Statement requirement in a small business chapter 11 and deem the plan itself adequate information to confirm a plan. 11 U.S.C. §1125(f).

II. CASES OUTSIDE THE “SMALL BUSINESS” DESIGNATION

Because a case qualifies as a “small business” under the Bankruptcy Code does not necessarily mean that it can proceed as such under. If the United States Trustee appoints a committee, the case will not proceed as a small business case unless and until the Court enters an Order finding the committee is not sufficiently active and representative. Fed.R.Bankr.P. 1020(b); 11 U.S.C. §101(52D). Unless that happens, however, the appointment of the Committee prevents the case from moving forward as a small business case.

The appointment of a creditors’ committee adds administrative costs to a small chapter 11, as the professional fees of the committee and any of its accountants, financial advisors, etc. will be borne by the estate. See 11 U.S.C. §503(c). Thus, a debtor and its counsel must remain mindful of the administrative costs and whether the debtor is capable of successful reorganization.

Some interesting reads and resources regarding the cost of reorganization for small businesses:

* Mount, Ian, “Adviser to Businesses Laments Changes to Bankruptcy Laws,” *New York Times* found at http://www.nytimes.com/2012/03/01/business/smallbusiness/bankruptcy-becomes-unaffordable-for-small-businesses.html?_r=0 (last visited August 2, 2016). Chuck Benjamin of Benjamin Capital Advisors discusses the effect of BAPCPA and *LaSalle*.

* Lawton, Anne, “A Case for Simplifying the Code’s Small Business Designation,” *American Bankruptcy Institute Law Review*, Vol. 21 (2013)

- Glick, Larry “Representing the Small Business Debtor in Chapter 11: Issues, Pitfalls, and Best Practices,” 2014 WL 10504 (January 2014): Best practices for assessing feasibility of successful reorganization

Chapter Six

Cases for Consumer Bankruptcy Practitioners

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Stendardo v. Fed. Nat'l Mortg. Ass'n, 991 F.2d 1089 (3d Cir. 1993)

A judgment extinguishes the obligation of a mortgage under the merger of judgments doctrine. Unless a mortgage agreement evidences the intent of the parties to the mortgage to have a given contractual provision survive judgment, said judgment becomes the sole basis for ascertaining damages.

In re Klaas, 858 F.3d 820 (3d Cir. 2017)

The court concluded that "§ 1328 directs bankruptcy courts to issue a completion discharge if the debtor has completed 'all payments under the plan.'" The court found, however, that §1328(a) does not include "an express requirement that such payments were made within five years." Thus, the Third Circuit determined that the bankruptcy court could exercise its discretion under § 1307(c) and not dismiss the case (for failure to complete the payments within five years) but instead was within its authority to grant the debtor a reasonable grace period to cure. Even though the grace period exceeded five years, the debtors' payment was still "under the plan," and §1328(a) then required a discharge.

The Klaas court set out a non-exhaustive list of factors a bankruptcy court should consider in deciding whether to allow a grace period:

- (1) whether the debtor substantially complied with the plan, including the debtor's diligence in making prior payments;
- (2) the feasibility of completing the plan if permitted, including the length of time needed and amount of arrearage due;
- (3) whether allowing a cure would prejudice any creditors;
- (4) whether the debtor's conduct is excusable or culpable, taking into account the cause of the shortfall and the timeliness of notice to the debtor; and
- (5) the availability and relative equities of other remedies, including conversion and hardship discharge.

In re Humes, 579 B.R. 557 (Bankr. D. Colo. 2018)

Disagreed with the *In re Klaas* court and found that there is a five-year temporal limitation for plan payments that cannot be discretionarily extended by the court and deemed the end of the term to be a "drop dead date."

In re Leahey, No. 11-11906-ABA, 2017 Bankr. LEXIS 3274 (Bankr. D.N.J. Sep. 26, 2017)

This case involved the debtors expecting proceeds from a cause of action (assuming they won in the future) that they did not disclose during the bankruptcy. There was no indication that the case was on the verge of either settling or having judgment entered, over a year after the bankruptcy case closed. *While Klaas extended a chapter 13 case to allow for a cure payment, it is doubtful that it could stand for the proposition that a chapter 13 case could be held open for years in order to allow for distribution of lawsuit proceeds, especially where the plan never accounted for or was modified to account for the potential law suit proceeds.* Also, debtors are

able to contribute proceeds from lawsuits that conclude during a plan, but when the cause of action does not even arise until more than two and a half years into a case, it is questionable whether a chapter 13 trustee would insist on the proceeds (again, assuming the Leaheys will win) be included in the plan.

Fraser v. CitiMortgage, Inc. (In re Fraser), 599 B.R. 830 (Bankr. W.D. Pa. 2019)

In this case, the debtor filed an adversary proceeding and an amended complaint challenging the secured status of a portion of the creditor's claim and sought to modify it after the Chapter 13 plan was confirmed. The creditor filed a motion to dismiss and the court granted it.

The court held that the Confirmation Order was res judicata and that the debtor could have brought an 11 U.S.C.S. § 506(a) proceeding prior to plan confirmation. Notwithstanding the res judicata effect of a confirmed plan, allowed claims can be reconsidered for cause pursuant to § 502(j) if the equities so warrant. Debtor's "cause" for reconsideration was entirely within his knowledge and control at the time of confirmation and as of the petition date; the equities of the case also supported disallowing reconsideration, and therefore, debtor had not met his burden of showing adequate cause for reconsideration.

Further the court held that even if plan modification under 11 U.S.C.S. § 1329 was allowed under the facts of the case, debtor did not plead facts to show a "substantial, material or unanticipated change in circumstances" to entitle him to such relief.

Denby-Peterson v. Nu2u Auto World, 595 B.R. 184 (D.N.J. 2018)

The central question presented by this appeal is what path this Court will take in the face of a split between the Circuit Courts — and no Third Circuit case law explicitly deciding the split - over the imposition of sanctions in cases of pre-petition repossession of vehicles.

The majority position, which is followed in the Second, Seventh, Eighth, and Ninth Circuit Courts of Appeals advises that a creditor violates the automatic stay when it fails to affirmatively and immediately return qualifying property of the debtor that was seized pre-petition. These courts interpret the 1984 addition to the Bankruptcy Code to broaden the scope of the automatic stay to require affirmative action.

The minority position, on the other hand, has only been followed in the Tenth and District of Columbia Circuit Court of Appeals. This position finds no violation of the automatic stay as long as the creditor merely maintains the status quo in effect at the time of the automatic stay. The minority position interprets the 1984 addition to the Bankruptcy Code to reach out to previously unaddressed actions to exercise control that do not result in actual possession.

Examining the law de novo, this Court found the minority position more persuasive. The minority rule wisely balances both sides. The minority rule still prohibits creditors from taking post-petition action that would give them possession or control over qualifying property. This ensures that the property will remain a part of the estate and allows for a bankruptcy court to distribute those assets to all claimants in an orderly and just manner. It also still allows damages

for wrongful post-petition conduct. Debtor's may still request a creditor to return property repossessed pre-petition and may still move for a turnover of the property before a bankruptcy court. This allows a bankruptcy court to fully consider a creditor's defenses to turnover before a creditor has to turnover property to the estate.

Turner v. CIT Bank, N.A., No. 3:17-CV-679, 2018 U.S. Dist. LEXIS 82299 (N.D.N.Y. May 16, 2018)

The debtors had a mortgage on their property that was unperfected and the bankruptcy court declared wholly unsecured early in the case. Later, the debtors sought to obtain a new mortgage against their residence to fund certain payments to the bankruptcy trustee in satisfaction of their debts. This is when the debtors began to receive correspondence from the old mortgagee claiming they were in default on their mortgage. The mortgagee moved the bankruptcy court for an order of contempt and an award of damages for emotional distress and attorney's fees from the old mortgagee on the basis of their alleged violation of the automatic stay. The old mortgagee did not respond to the motion and the bankruptcy court granted the contempt motion in part because the correspondence from the mortgagee lacked certain disclaimers indicating that they were for "informational purposes only," and denied in part because some documents did in fact contain an informational disclaimer. The debtors appealed the denial of part of the motion, arguing the court applied the wrong standard.

The court stated the standard, that a party seeking damages for a violation of the automatic stay must prove the following elements: (1) that a bankruptcy petition was filed, (2) that the debtor is an individual, (3) that the creditor received notice of the petition, (4) that the creditor's actions were in willful violation of the stay, and (5) that the debtor suffered damages. Based on this standard, the district court affirmed the bankruptcy court's decision that informational mailings are generally not considered automatic stay violations (unless it is provided in a manner "which is threatening, harassing or coercive").

The district court also affirmed the bankruptcy court's denial of the debtors' request for an evidentiary hearing on their motion, stating there was nothing improper about the bankruptcy court's refusal to hold further proceedings before disposing of appellants' contempt motion.

Berger v. Pa. (In re Berger), Nos. 18-20778-GLT, 18-02130-GLT, 17-23757-GLT, 18-02163-GLT, 2019 Bankr. LEXIS 1126 (Bankr. W.D. Pa. Mar. 29, 2019)

Pennsylvania Department of Revenue's motions to dismiss were denied. Holdings: [1]-Sovereign immunity did not prohibit debtors from removing unsecured or undersecured tax liens from their property because the taxing authority waived sovereign immunity when it filed a proof of claim in each of the debtors' bankruptcy cases, and the claims arose out of the same "transaction or occurrence" that gave rise to debtors' claims--that is, their adversary complaints seeking to strip the tax liens; [2]-Alternatively, sovereign immunity was abrogated by Congress pursuant to 11 U.S.C.S. § 106(a); [3]-Also, the taxing authority never had sovereign immunity because determining rights in a piece of property was properly an in rem proceeding.

Ruth v. Swigert (In re Swigert), No. 1:18-bk-04351-HWV, 2019 Bankr. LEXIS 1022 (Bankr. M.D. Pa. Apr. 1, 2019)

The Court rejected the concept of a per se prohibition against concurrent filings and adopted in its place an analysis of debtors' good faith as it related to the subsequent and concurrent petition. The debtors' good faith was adequately called into question by the facts of this case as set forth in the creditor's Motion to Dismiss. The burden then shifted to the debtors to prove their good faith. In re Tamecki, 229 F.3d 207.

The Third Circuit instructs bankruptcy courts to look to the totality of the circumstances to determine if bad faith exists and may consider a wide range of factors. In re Myers, 491 F.3d at 125. Those factors include "the nature of the debt . . . ; the timing of the petition; how the debt arose; the debtor's motive in filing the petition; how the debtor's actions affected creditors; the debtor's treatment of creditors both before and after the petition was filed; and whether the debtor has been forthcoming with the bankruptcy court and the creditors." The court here focused on:

- (i) the timing of the petition,
 - a. The court held that suspicious timing of the petition demonstrated a lack of good faith, as it was deliberately timed to circumvent 11 U.S.C.S. § 109(g)(2), which otherwise would have rendered them ineligible to file for a period of 180 days, and weighed heavily in favor of a finding that cause to dismiss this case existed under 11 U.S.C.S. § 1307(c);
- (ii) the debtors' motive, and
 - a. Debtors' motive was to improperly impose a new automatic stay to circumvent a prior order of the court, which was an abuse of the bankruptcy law and also demonstrated that filing the petition in this case was not in good faith;
- (iii) how the debtors' actions affected creditors.
 - a. Debtors' actions had a significant and detrimental effect upon the creditors, and debtors knew their actions would have this effect as it was necessary to achieve their goal of retaining pledged vehicles.

Chapter Seven

Tax Issues in Bankruptcy

Chapter Seven
Section 1

A Tax Issue Guide for Bankruptcy Practitioners

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A Tax Issue Guide for Bankruptcy Practitioners

Part I:

TAX ISSUES THAT BANKRUPTCY PRACTITIONERS NEED TO CONSIDER

- I. Negotiating with the Internal Revenue Service and Other Tax Agencies versus Filing a Bankruptcy Petition
 - A. Currently Non-Collectable Status (CNC)
 - B. Installment Agreements
 - C. Partial Pay Installment Agreements
 - D. Offers in Compromise
 - E. Installment Agreements
 - F. Penalty Abatements
 - G. The Do-Nothing-at-All Approach
 - H. Challenge Assessment
 - I. Seeking a Refund (the ideal remedy for resolving the business withholding tax and trust fund recovery penalty)
 - J. Statutes of Limitations
- II. Other and Better Forums and Why

- A. Federal District Court
- B. United States Tax Court
- C. United States Court of Federal Claims
- D. Bankruptcy Court
- E. PA Commonwealth Court

III. Strategic Considerations

- A. Dealing with IRS ACS Personnel
- B. Dealing with IRS Revenue Officers
- C. Dealing with Special Procedures Officers
- D. Dealing with Appeals Officers
- E. Dealing with District Counsel
- F. Dealing with Justice Department Counsel
- G. Dealing with U.S Attorneys
- H. Dealing with C.I.D. and F.B.I.
- I. Dealing with PA Department of Revenue Representatives
- J. Dealing with PA Attorney General Representatives

IV. Important Tax Issues beyond Sections 523 and 506 of the Bankruptcy Code

- A. Discharge of Indebtedness and Its Exceptions
 - Kirby Lumber* and Progeny
- B. Bankrupt Individuals and their Estates
 - i. In General
 - ii. Transfer of Tax Attributes between Debtor and Estate
 - iii. Loss Carrybacks

iv. Allocation of Income and Expense between Debtor and Estate

- C. Tax Treatment of the Debtor
- D. Tax Treatment of the Estate
- E. Abandonment of Property by the Estate
- F. Cases under Chapter 13
- G. Dismissed Cases

V. Receivership, Foreclosure and Similar Proceedings

- A. Corporations
- B. In General
- C. Types of Reorganizations
- D. Tax Effects of Insolvency Reorganizations and Liquidation
- E. Partners and Partnerships
- F. Section 1398 not applicable to bankrupt partnerships; estate of bankrupt partner treated as partner
- G. Transfer of partnership interest to the bankruptcy estate
- H. Taxable years of an individual partner in the bankruptcy estate
- I. Proceedings to determine partnership income

Part II:

RULES RELATING TO DISCHARGEABILITY OF TAXES IN BANKRUPTCY

NOTE: When addressing a tax issue in bankruptcy, a practitioner must recognize the complexity of issues at hand. While dischargeability is but one issue, the complexity of that issue alone can be recognized by the fact that Morgan D. King's treatise on dischargeability is 915 pages, excluding the annual supplement. See, *Discharging Taxes In Bankruptcy*, Kings Press, (2000 Ed.)(Supp. 2005). www.Kings-Press.com.

With that note, we begin.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L No. 109-8, § 714(2), 119 Stat. 128-129, curtailed the "super-discharge" in chapter 13. It did not, however, alter the rules relating to dischargeability in chapter 7.

There are **six rules** for discharging federal and state **income** taxes in chapter 7.

The tax is dischargeable **if all** of the following conditions **exist**:

The Three-Year Rule. For the tax year in question – the most recent due date for filing the return is more than three years old. The three-year period is computed from most recent date the tax return is due for the tax year (typically April 15th of the year following the taxable year.) An extension to file the return delays the start of time. Always check to see if the due date falls on a holiday or weekend. Check back three years every April 15 and October 15. 11 U.S.C. §507(a)(8)(A)(i).

The Two-Year Rule. The tax return or equivalent report or notice, if required, has been filed or given by the taxpayer for the tax year in question at least more than two years preceding the filing of the bankruptcy. 11 U.S.C. §523(a)(1)(B).

Issue: What is a return? There are three conflicting approaches that have been adopted and are discussed in Part III of this outline. This issue applies only to the “two-year” rule.

The 240-Day Rule. The tax claim was assessed at least more than 240 days preceding the filing date of the bankruptcy. 11.U.S.C. §507(a)(8)(A)(ii).

Tax is Assessable But not Yet Assessed. Look for Tax Court case, pending audit consent to extension to assess. 11.U.S.C. §507(a)(8)(A)(ii).

Non-Fraudulent-Return. A tax return cannot be fraudulent. 11.U.S.C. §523(a)(1)(C).

No Willful Tax Evasion. The taxpayer must not have engaged in activity deemed to be a willful attempt to defeat or evade the tax. 11.U.S.C. §523(a)(1)(C).

Issue: What is Fraud or Willful evasion? Should you flush out the issue prior to the conclusion of the case? How bad do you have to be? Majority rule is there must be more than a mere failure to file.

Potential Fraud and Willful Evasion Checklist

Compiled by Morgan King, Mark Segal, Kent Anderson and Larry Heinkel as presented in Outlines at Conferences of the National Association of Consumer Bankruptcy Attorneys

1. Membership in a tax protest organization.
2. Engaged in a pattern of unfiled returns.
3. Filed a fraudulent, frivolous, blank or incomplete return.
4. Repeatedly understated income or overstated deductions.
5. A serial failure to pay taxes.

6. Concealed, gave away or traded away valuable assets, or transferred title.
7. Sold assets, significantly below fair market value, especially to insiders, such as family members, employers and business associates.
8. Set up “abusive” trusts or sham tax shelter and transferred assets to it. An abusive trust probably exists if the debtor was facing tax then at the time of the set up and he remains in control of, or benefit use of, assets of the trust.
9. Is the taxpayer a beneficiary of family trusts, business trust or other trust?
10. Did the taxpayer set up the trust?
11. Did the taxpayer transfer valuable assets to the trust?
12. Did the taxpayer have unfettered control of trust assets?
13. Does the taxpayer have benefit of the use of trust assets?
14. Are the taxpayer’s personal living expenses paid by the trust?
15. Does he not report trust payments as taxable income to himself?
16. The trust has no “economic reality.”
17. Created a corporation and transferred assets to it.
18. Changed bank or bank account frequently.
19. Closed bank account and conducted business in cash only.
20. Added another person’s name to the bank account.
21. Deposited income in another’s bank account.
22. Used a foreign bank account.
23. Changed name or changed spelling of name.
24. Changed social security number.
25. Had an altercation with a revenue officer.

26. Engaged in money laundering.
27. Withdrew cash from bank and hid it. *See In Re Bernard* 96 F.3d 1279 where the Debtor simply withdrew \$64,000.00 from a bank account in order to keep it away from a levy-this was held to be a fraudulent transfer and discharge denied.
28. Claimed incorrect number of exemptions on a tax return.
29. Purchased property in someone else's name.
30. Refused to cooperate with a revenue officer, or deliberately obstructed audit or investigation.
31. Loss, concealed or destroyed financial documents.
32. Maintained inadequate records.
33. Concealed actual residence address or business address.
34. Traded valuable assets for less valuable assets.
35. Devising clever schemes such as divorcing his wife and directing all income to her and renting a room in her house thus eliminating most income that could be traced to husband to satisfy husband's tax claims.
36. Living a "lavish lifestyle" knowing that delinquent taxes had not been paid.

Discharge of Income Tax in Chapter 13

Taxes arising as a result of fraud or willful misconduct were once dischargeable under section 523(a)(1)(B) and (C). Following the enactment of BAPCPA, such conduct is no longer dischargeable. The same six rules apply for chapter 13 as for chapter 7. However, note that a section 507 priority income tax is not dischargeable in chapter 7, but is technically dischargeable in chapter 13.

BAPCPA Makes Post-Petition Interest an Issue

Interest on tax claims in chapter 13 continues to accrue during the plan. The issue is whether post-petition interest is discharged. In most jurisdictions, accruing post-petition interest on an unsecured non-dischargeable claim cannot be paid through the plan unless a plan is a 100% plan. So what happens to the post-petition interest? BAPCPA makes section 523 income taxes and section 507 trust fund taxes non-dischargeable. Interest follows the tax. Therefore, the tax is non-dischargeable and neither is the interest. *In re Monahan*, 2013 WL 5289741 (Bankr. 1st Cir. Bap).

The super-discharge still applies to some extent. Priority personal income tax, never dischargeable in a chapter 7, is dischargeable in a chapter 13 if the IRS fails to file a timely proof of claim. Also, the super-discharge remains for non-pecuniary tax penalties. Penalties are never priority taxes and are dischargeable no matter when assessed or when the triggering event happened. Interest on the penalty is also dischargeable. Payroll trust fund taxes are priority non-dischargeable, but only the section 941 claim. Therefore, you should avoid scheduling the entire 941 debt as a priority in the schedules and plan.

Issue: What if the tax is a section 523 tax and is unassessed? If so, it will not be a priority tax and will not be paid. Therefore, you need to create priority status by filing the tax return prior to filing the bankruptcy, waiting until the tax is assessed and filing the petition within 240 days of the tax assessment date.

Tolling and Delaying Events

1. A prior bankruptcy tolls the three-year period plus 90 days and tolls the 240 day period plus 90 days to the extent of an overlap. It no longer adds six months to the three-year tolling period. There is no tolling of the two year period.

2. Extension to file return delays the start of the three-year period and extends the due date to October 15.

3. Tax litigation delays assessment and the start of the 240-day assessment period. We also need to add in the time period in which an appeal can be filed.

4. An offer in compromise tolls the 240-day period for which the time the OIC was in effect or pending plus 30 days. An offer in compromise can be deemed to be “in effect” for years if the offer settlement was structured as a monthly payment plan. The OIC does not usually toll the three-year period. Section 507(a)(8)(A)(ii) does not mention the three-year rule.

5. A request for a Collection Due Process Hearing tolls both three-year and 240-day periods.

AN IMPORTANT STRATEGIC NOTE: An installment plan does not toll. It is a great way to keep the wolves at bay while waiting for certain time periods to expire, including the 3-year, 2-year and 240-day periods discussed above and the 10-year statute of limitations on collections.

GET: Tax Account Transcripts

You must refer to the IRS “Account Transcripts” to determine whether all of the six rules have been satisfied, whether or not there have been any tolling events, and whether liens have been recorded. According to Morgan King and Mark Segal and based upon my experience, the easiest way to obtain an Account Transcript is to call the IRS Priority Hotline which can get the transcripts to you within 24 hours with no charge. You will need your client to sign IRS Form 8821 or 2848. You will have the client’s name and social security and address at hand as well as a fax number. The Priority Hotline telephone number is (866) 860-4259. Explain that you are

an attorney or POA holder and need account transcripts for your client. You can also now obtain Account Transcripts direct on the IRS website following registration.

A Few Comments about Tax Liens In Bankruptcy

The secret lien can be avoided.

Tax liens pierce exemptions but do not attach to after-acquired property.

A lien survives the bankruptcy but only as to property owned by the debtor at the time of the bankruptcy filing.

You can do lien stripping in a chapter 13, but not lien avoidance.

The tax lien covers all realty and personalty.

For the lien to attach, it must be filed where the taxpayer's asset or assets are found.

You can do online searches for tax liens at Accruent.com.

Tax liens are self-releasing.

Part III:

ISSUE IN THE FOREFRONT TODAY

Filing a Tax Return One Day Later Precludes Dischargeability

According to Timothy M. Todd, “[t]he current rule... [in the First, Fifth and Tenth Circuits] for handling the discharge of tax debt related to a tardily filed tax return is severely distorted and antithetical to sound bankruptcy and taxation policy.” *Discharge of Late Tax Returns in Bankruptcy: Fixing BAPCPA’s Draconian Hanging Paragraph*, American Bankruptcy Institute Law Review, Volume 24, Number 2, p. 433 (Summer 2016).

The First, Fifth and Tenth Circuits hold that the “hanging” paragraph of Section 523(a) prohibits discharge of taxes if a taxpayer files a return *even* one day late. The “hanging” paragraph was part of the 2005 BAPCPA amendments to the Bankruptcy Code.

The Fourth, Sixth, Seventh, Eighth and Eleventh Circuits, on the other hand, employ the four-part test resulting from a 1984 Tax Court decision known as *Beard*. (See discussion latter in this outline.)

Addressing the question, the Third Circuit joined the majority in a May 5, 2017 opinion by adopting the *Beard* test. See, *Giacchi v. United States*, 15-3761 (3d Cir. May 5, 2017).

Deepening the controversy over late-filed tax returns, however, the *Giacchi* Court weighed in on a subordinate split by differing with the Eighth Circuit and considering the timing of the late-filed return as relevant to the question of dischargeability.

According to Rochelle’s Daily Wire published by the American Bankruptcy Institute, the Supreme Court has been ducking the split. Columbia University Law Professor Ronald J. Mann

attempted to take a one-day-late case to the Supreme Court in 2015 in *In re Mallo*. The high court denied *certiorari*. In February, 2017, the justices denied *certiorari* in [*Smith v. IRS*](#), where the petitioner's counsel raising the same issue was Prof. John A.E. Pottow from the University of Michigan Law School.

See, <https://www.supremecourt.gov/search.aspx?filename=/docketfiles/16-497.htm>

As an overview, a debtor who receives a discharge under chapter 7 of the Bankruptcy Code is generally discharged from personal liability for all debts incurred before the filing of the petition. 11 § U.S.C. 727(b). Under 11 U.S.C. §523, however, certain debts are exempt from discharge. For example, a discharge does not cover “any debt” - -

- (1) For a tax or a customs duty - -
 - (B) With respect to which a return or equivalent report or notice, if required –
 - (i) was not filed or given; or
 - (ii) was filed or given after the date on which such return, report, or notice was due under applicable law or under any extension, and after two years before the date of the filing of the petition. 11 U.S.C. 523(a)(1)(B).

Under this provision, tax debts which respect to which no return was filed are non-dischargeable. Tax debts with respect to which a return was filed late are potentially dischargeable, so long as the return was filed two years or more before the bankruptcy petition was filed.

With BAPCPA, Congress added a definition of “return” to an unnumbered hanging paragraph at the end of Section 523(a), by defining it to mean a return that satisfies the requirements of applicable non-bankruptcy law (including applicable filing requirements).

According to the IRS, such term includes a return prepared pursuant to Section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a non-bankruptcy tribunal, but does not include a return made pursuant to Section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.

Section 6020(a) of the Internal Revenue Code authorizes the Secretary of the Treasury to prepare a return for a taxpayer if the taxpayer provides “all information necessary for the preparation thereof.” 26 U.S.C. 6020(a). Section 6020(b) authorizes the Secretary to prepare a return for a taxpayer without the taxpayer’s cooperation, based on the information available to the Secretary at the time. 26 U.S.C. 6020(b).

The “applicable non-bankruptcy law” here is federal tax law. The Internal Revenue Code does not define the term “return.” It is well-accepted, however, that a filing qualifies as a “return” for purposes of federal tax law if it provides “sufficient data to calculate tax liability”; the filing “purport[s] to be a return”; the taxpayer has made “an honest and reasonable attempt to satisfy the requirements of the tax law”; and the taxpayer has “execute[d] the return under penalties of perjury.” *Beard v. Commission*, 82 T.C. 766, 777 (1984), *aff’d*, 793 F. 2d 139 (6th Cir. 1986) (per curiam); *See Badaracco v. Commissioner*, 464 U.S. 386, 397 (1984); *Zellerbach Paper Co. v. Helvering* 293 U.S. 172, 180 (1934); *Florsheim Bros. Drygoods Co. v. United States*, 283 U.S. 453, 461-462 (1930). This is known as the *Beard* test.

The issue of non-dischargeability for late filed returns started in the late 1990’s with the Opinion of the United States Court of Appeals for the Sixth Circuit in *In re Hindenlang*, 164 F.3d 1029 (6th Cir.), *cert. denied*, 528 U.S. 810 (1999), where the Court held that a Form 1040 filed after the Internal Revenue Service made an assessment against the debtor/taxpayer using

Internal Revenue Code (“IRC”) Section 6020(b) procedures did not qualify as a “return” for purposes of triggering the running of the two-year waiting period in Bankruptcy Code Section 523(a)(1)(B)(ii).

In *Hindenlang*, the Internal Revenue Service assessed Mr. Hindenlang using the substitute-for-return provisions in IRC Section 6020(b). Subsequently, he filed his own Form 1040 containing information that was identical to the information on the substitute-for-return that the Internal Revenue Service prepared.

As a result, the United States Court of Appeals for the Sixth Circuit concluded that Mr. Hindenlang’s subsequent tax return did not meet the test enunciated under *Beard* to qualify as a “return.” As a result, a “return” was not filed under Bankruptcy Code Section 523 within two years of Mr. Hindenlang’s bankruptcy filing.

The irony of the case is that, while it was favorable to the Internal Revenue Service, it conflicted with the procedure that the Internal Revenue Service used for processing discharged debts. As a result, it pressed for a change to Section 523 and, as a result, the “hanging” paragraph in Section 523 was added by the 2005 amendments to the Bankruptcy Code for which the three circuit courts have found to be a clear rule that is easily administrable, but one that clashes with another Bankruptcy Code section and creates an extremely harsh result that the Internal Revenue Service does not embrace.

The Three Post-BAPCA Positions:

The First, Fifth and Tenth Circuits hold that tax debt arising from a late filed return **can never be discharged** in bankruptcy. *See also, Fahey v. Mass. Dep’t of Revenue (In re Fahey)*, 779 F.3d 1, 7 (1st Cir 2015); *McCoy v. Mississippi State Tax Commission*, 666 F.3d 924 (5th Cir.

2004) and *Mallo v. Internal Revenue Serv. (In re Mallo)*, 774 F.3d 1313, 1327-28 (10th Cir. 2014).

A second approach is the one taken by the IRS in a 2010 Chief Counsel Notice that if a taxpayer files a return prior to the date that the IRS makes an assessment or a return is prepared pursuant to IRC Section 6020(a), the tax debt can be discharged. This is more or less consistent with the *Hindenlang* decision.

A third approach is the pre-BAPCPA approach of *Colsen v. United States (In Re Colsen)*, 446 F.3d 836, 839 (8th Cir. 2006), where the court held that reference to “applicable non-bankruptcy law” incorporated *Beard*, which made no mention of timeliness. *See, In re Martin*, 482 B.R. 635, 2012 WL 5554611 (Bankr. D. Colo.), which was cited with approval in *Brown v. Mass. Dept. of Rev.* 2013 WL 951797, where the Court stated that the “applicable filing requirements” as used in the Bankruptcy Code defining “return” did not encompass the time for filing a return but instead referred to objective considerations such as the form and content of a return, the place and manner of filing and the types of taxpayers that were required to file a return. *Martin* was reversed, notwithstanding the district court declining to apply *McCoy*. *See, In re Martin*, 500 B.R. 1, 8 (D. Colo. 2013), *aff’d*, 774 F.3d 1313 (10th Cir. 2014).

In response to the conflict in the three approaches, Professor T. Keith Fogg, a professor at the Villanova Law School, asserts in his Blog, “Procedurally Taxing,”¹ “[t]his mess of differing positions between the courts, the states and the Federal government has left the discharge of taxes when the taxpayer files a late return—something that happens hundreds of thousands of times each year – in disarray. The uncertainty causes different governments to keep or remove taxes in different ways and will have a lasting impact for the duration of the statute of limitations

¹ See Blog post of June 9, 2015.

on collection unless the governments have carefully marked these cases to allow a quick fix once the dust settles on the issue.”

In May of 2017, the Third Circuit weighed in on the issue in *Giacchi v. United States*, 15-3761 (3d Cir. May 5, 2017), where it continued a trend away from the one-day rule and held that the debtor’s taxes were non-dischargeable based on the application of the *Beard* test. (See earlier.)

Following the pattern of other recent cases on this issue, the Third Circuit stated that it did not need to reach the one-day rule because it found that the Forms 1040 filed by Mr. Giacchi after the IRS had already assessed the taxes based on IRC 6020(b) determination of the liability and a failure by Mr. Giacchi to petition the Tax Court in response to a statutory notice of deficiency were not a genuine effort to file a tax return but were simply forms filed to qualify Mr. Giacchi for discharge. The Court could have avoided having to make the determination based on the valid return issue if it had decided based on the one-day rule. So, the decision, like the recent decisions in other circuits, serves as an implicit repudiation of the one-day rule even though the Third Circuit does not directly take on the statutory language and seek to resolve the issue directly. See Blog post of Professor T. Keith Fogg dated May 31, 2017.

According to Professor Fogg, the resolution of the issue in the manner in which the Third Circuit resolves this case does little to fix the problem the IRS has of administering discharges to determine when it may write off tax liabilities. The Court did not adopt the bright line rule sought by the IRS that would make any Form 1040 filed after the IRS makes an IRC 6020(b) assessment unqualified to meet the test of a return; however the Court comes about as close as you can come to setting out that conclusion without explicitly doing so. The case presents a

strong victory for the IRS and will prevent just about any taxpayer in the Third Circuit from getting a discharge once the IRS makes an IRC 6020(b) assessment.

Part IV:

MISCELLANEOUS TAX ISSUES OF NOTE

1. The Clerk of the Bankruptcy Court of each district must maintain a listing of Federal, state, and local governmental units that have designated an address for service of requests and describe further information concerning additional requirements for filing such requests. If a governmental unit fails to provide an address to the Clerk, requests should be served at the address for filing returns or protests for that governmental unit.

2. Under the prior law, there was no uniform rate of interest applicable to tax claims. As a result, varying standards were used. Most often, market rates of interest were used. Now, Section 511 applies in all cases where interest is required to be paid on tax claims or on an administrative expense tax, and to enable a creditor to receive the present value of the allowed amount of a tax claim. Under Section 511, the rate to be used will be determined by applicable non-bankruptcy law. For Federal taxes, most likely the rate will be based on a market rate. For state and local taxes, there may only be a limited relationship to the market rate. With respect to confirmed plans, the interest rate is determined as of the calendar month in which the plan was confirmed.

3. Section 523(a)(14A) provides that, for debts “incurred to pay a tax to a governmental unit, other than the United States, that would be nondischargeable under paragraph (1)... [of Section 523].” Thus, if the debtor borrows money for the purpose of paying a state or local tax,

that debt would be nondischargeable provided that the underlying tax is also nondischargeable under Section 523(a)(1).

4. Under prior law, the confirmation of a Chapter 11 plan discharged a corporate debtor from most debts. Now, Section 1141(d) provides that confirmation of a plan does not discharge a corporation from: (1) a debt incurred under Section 523(a)(2)(A) or (B) (by false pretenses or by making false statements in writing to a domestic governmental unit); and (2) a debt for a tax with respect to which the debtor filed a fraudulent tax return or willfully attempted, in any manner, to evade or defeat such tax.

5. IMPORTANT NOTE: Code Section 362(b)(9) does not operate as a stay against an audit, a demand for a tax return, the issuance of a 90-day letter (i.e., a notice of deficiency) or the making of an assessment for any tax and issuance of a notice and demand for payment of such an assessment (but any tax lien that would otherwise attach to property of the estate by reason of such an assessment shall not take effect unless such tax is a debt of the debtor that will not be discharged in the case and such property or its proceeds are transferred out of the estate to, or otherwise re-vested in, the debtor.) (I am assuming that this provision was added so that the IRS can obtain lien priority over other creditors after the case concludes or dismissed.)

6. Individuals no longer receive a discharge at the time of confirmation but now receive a discharge upon completion of all plan payments unless the debtor specifically applies for a “hardship discharge.”

7. IRC Section 1398 creates a separate taxable estate for individual debtors filing chapter 7 or 11 cases. Individuals filing chapter 13 cases do not have a separate taxable estate created. New Bankruptcy Code Section 1115 creates in chapter 11 cases a rule providing that all post-petition property of the debtor, and all post-petition earnings from services, is property of

the bankruptcy estate until the case is closed, dismissed, or converted. This raises questions concerning the extent to which income from post-petition services and income from post-petition property is taxed to the estate, rather than the debtor, and whether confirmation of the chapter 11 plan (and re-vesting of property in the debtor) has an impact on the taxation of the estate. The Service will publish guidance that attempts to address the uncertainty created by new section 1115 and its interaction with section 1398 of the IRC.

8. The automatic stay prevents the commencement of or continuation of a Tax Court proceeding. Halpern v. CIR, 96 TC 895 (1991). The opinion was very broad. Section 362(a)(8) was amended to clarify the scope of the automatic stay.

A. First, see the above exception.

B. Section 362(a)(8)—was the only change made by BAPCPA to Section 362(a):

****For Corporations** – the stay applies for any period the Bankruptcy Court may determine tax (pre and post filing).

**** For Individuals** – the stay applies only to a tax liability for a taxable period ending before the order for relief.

Thus, the TC can get jurisdiction over individuals for post-petition periods.

9. Section 362(b)(18) expands the exception for the creation or perfection of statutory liens for *ad valorem* property taxes, to add an exception for special taxes and assessments on real property whether or not they fall within the *ad valorem* category.

10. Section 362(b)(26) sets forth an exception to permit setoff under applicable nonbankruptcy law of an *income* tax refund by a governmental unit as to a taxable period ending before the order for relief against a tax liability for a period ending before the order for relief, unless nonbankruptcy law does not permit the setoff.

11. Section 505(b) provides that a debtor in-possession or trustee may request a determination of any unpaid liability of the estate for any tax incurred during the administration of the case at the time the tax return is filed. If upon payment of the amount shown on the return, the trustee, debtor, and any successor to the debtor is discharged, unless a governmental unit notifies the trustee or debtor-in-possession within 60 days that the return has been selected for examination and completes the examination within 180 days after the request was made. The 2005 Act modifies Section 505(b) to discharge the estate as well.

12. Section 1125(a)(1) is expanded by requiring the proponent of the plan to include a full discussion of the potential material Federal and state tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interest in the case.

13. Under the old law, priority tax claims could be paid in no specific fashion over a period of time not to exceed six years from the date of assessment. Under the post-BAPCPA Section 1129(a)(9)(C), priority tax claims must be paid in full in regular cash installments to be paid within five years of date from order for relief.

Further, tax claims must be paid in a manner at least equal to the most favorable treatment of nonpriority unsecured claims (except administrative convenience class) under the plan. The same rule applies to secured claims that would otherwise qualify as priority tax claims.

14. An election for a short year for an individual must be made by 15th day of fourth full month after the petition is filed. There are no exceptions. One should plan liquidations to use taxable gains (rather than COD income) to offset NOL carryforwards.

15. One should carefully see that the plan does not provide for a discharge of debts.

- a. Once the debtor has been dissolved, COD may occur at anytime, but with no impact.
- b. See, PLR 200414019(Apr. 2, 2004) and PLR 200445020 (Nov. 12, 2003)

16. Under Section 521, a taxing authority may move for conversion or dismissal if a debtor fails to file tax returns or properly request an extension. After a request is filed by the taxing authority, the debtor has 90 days to file a return or request for an extension.

17 Section 1112(b)(4)(l) and 1307(e) specifically enumerates that the failure to keep current on taxes **shall be a basis for dismissal**, absent unusual circumstances. That are not in the best interests of creditors and the estate.

18. Section 521 requires that a debtor provide copies of certain tax information to the court, trustees, and/or creditors. This requirement raises a host of privacy concerns relating to the debtor's personal and financial information. See Section 521(e)(2)(A)(i); Section 521(f); Section 107.

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Chapter Seven
Section 2

Where Tax Resolution and Bankruptcy Meet

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Where Tax Resolution and Bankruptcy Meet

I. Types of Tax Claims

Three types of tax claims:

A. Secured Tax Claims

- A tax claim is secured when the IRS properly **perfects** a lien/security interest.
- For a lien to be properly perfected it must be filed in the proper place:
 - Prothonotary/Clerk where the taxpayer resides in most cases
 - Secretary of State for businesses plus the Prothonotary/Clerk if the business owns real estate
 - FAA for airplanes
 - DMV for cars, motorcycles, etc.
- When a valid Notice of Federal Tax Lien (“NTFL”) is filed prior to the bankruptcy, the lien ordinarily attaches to all property and rights of the taxpayer (real or personal). IRC Section 6321.
- Once filed, attaches to any after acquired property. Glass City Bank v. United States, 326 U.S. 265 (1945). Referred to as “Secret Lien.”
- If the lien is not properly perfected, there is no security interest.
- If there is no security, the claim can be reclassified as priority or general unsecured.

B. Priority Tax Claims

Priority claims are not secured but entitled to priority treatment under Section 507(a)(8) of the Bankruptcy Code.

To be classified as priority, an income tax claim must fall within the 3 year-2 year-240-day rule. (Due date-Filing-Assessment).

Other claims such as trust fund taxes are always considered priority claims. Section 507(a)(8)(c).

- **Three-year rule (Return due date) - Return was originally due at least three years before filing for bankruptcy. §507(a)(8)(A)(i)**
 - Between January 1st and April 15th - Last 4 Years Never Dischargeable.
 - After April 15th - Last 3 Years Never Dischargeable
 - Be Wary of Holiday Weekends and Extensions - extension effectively changes the due date from April 15th to October 15th
 - Be Wary of Tolling such as Prior Bankruptcy (Time In BK + 90 days) and CDP Appeal (Time in Appeal + 90 days)

- **Two-year rule (Filing) – Return filed at least two years before filing bankruptcy (§523(a)(1)(B))**
 - Filed by Taxpayer and Not Substitute for Return (SFR) – Some circuits hold that a late filed return cannot be discharged: the “one day late rule”.
- **240 Day Rule (Assessment) - IRS assessed tax at least 240 days before the debtor filed for bankruptcy. § 507(a)(8)(A)(ii).**
 - **Assessable but not assessed is not dischargeable. § 507(a)(8)(A)(ii).**
 - Be Wary of Multiple Assessments (each assessment runs on it own)
 - Be Wary of Tolling Events
 - Prior Bankruptcy (Time in BK + 90 days)
 - OIC (Time in OIC + 30 days)
 - CDP Appeal (Time in Appeal + 90 days)

C. General Unsecured Tax Claims

A claim is a “general unsecured” claim if it is not priority and not secured.

Penalties (failure to file, pay, deposit, etc.) are general unsecured claims if the transaction occurred more than 3 years before the petition date. §507(a)(7).

II. The Basics: Dischargeability

Whether a claim is entitled to priority under 507(a)(8) determines dischargeability of the tax claim pursuant to 523(a).

- **Type of Tax Test:**
 - **Income Tax:** Yes, if meets 3/2/240 rule.
 - **Trust Fund Recovery Penalty/Civil Penalty (Employee’s Portion of FICA and Income):** No, never. (§§523(a)(1) and 507(a)(8)(C)).
 - **Excise Tax:** Yes, if due more than three years before petition date, or if no return filed transaction occurred more than 3 years before the petition. §§523(a)(1)(A) and 507(a)(8)(E).
 - **Employment Taxes (Employer’s Portion of FICA and FUTA):** Yes, if return was due more than 3 years before the petition date. §§507(a)(3) and 507(a)(8)(D).
- **Meets 3/2/240 rule**
- **No Fraud or Willful Evasion § 507(a)(1)(c)**

- **Liens are not discharged even if the lien relates to a dischargeable tax** *In re Isom*, 901 F. 2d 744 (9th Cir. 1990)

III. Statute of Limitations

- The IRS has 10 years from the date of assessment to collect the tax.
- The date the statute runs on collecting the tax is commonly referred to as the CSED (Collection Statute Expiration Date).
- Bankruptcy tolls the CSED by the time in bankruptcy plus six months.
- Other items that may extend the CSED I.R.M. 5.1.19.3:
 - Judgment/Litigation - (Per IRC 6502(a) a court action brought against the taxpayer for the collection of tax prior to the expiration of the collection statute extends the period to collect until the tax liability or judgment against the taxpayer is satisfied or becomes unenforceable)
 - Offers in Compromise - (Time in Offer + 30 days following rejection and during period while rejection is considered in appeals)
 - Collection Due Process - (Time in CDP, unless only 90 days left on statute, then extended to equal 90 days)
 - Installment Agreement - (Suspended while pending, 30 days following rejection of installment agreement, if appeal is requested, while in appeals, during 30 days after date of termination, and if appeal is requested during period while termination is in appeals).

IV. Non-Bankruptcy Options

“If all you have is a hammer, everything looks like a nail.”

- Abraham Maslow

Yes, sometimes, bankruptcy is the best option to resolve a tax issue, but sometimes:

- tax issues can be resolved without bankruptcy.
- you should resolve a tax issue before filing a bankruptcy petition.
- you should resolve a tax issue after bankruptcy discharge.
- Non-Bankruptcy Options
- Penalty Reduction
- Offers in Compromise
- Payment Plans

- Financial Hardship Plans
- Wage Garnishment/Bank Levy Releases
- Federal Tax Lien Releases

A. Penalty Abatement

- Two types of penalty abatement:
 - First-Time Abatement – Available if...
 - You didn't previously have to file a return, or you have no penalties for the 3 tax years prior to the tax year in which you received a penalty.
 - You filed all currently required returns or filed an extension of time to file.
 - You have paid, or arranged to pay, any tax due.
 - Reasonable Cause Penalty Abatement (sound reason exists for the issue giving rise to the penalty) – Reasonable cause can be...
 - Fire, casualty, natural disaster or other disturbances
 - Inability to obtain records
 - Death, serious illness, incapacitation or unavoidable absence of the taxpayer or a member of the taxpayer's immediate family
 - Other reason which establishes that you used all ordinary business care and prudence to meet your Federal tax obligations but were nevertheless unable to do so.
- Pairs well with bankruptcy when:
 - A chapter 7 debtor has penalties on non-dischargeable tax debt
 - A chapter 13 debtor has priority/secured tax debt with penalties and wishes to pay less to the IRS

B. Offers in Compromise

An offer in compromise (OIC) allows you to settle your tax debt for less than the full amount you owe. It may be a legitimate option if you can't pay your full tax liability or doing so creates a financial hardship.

Three types of OIC:

- Doubt as to Liability (DATL);
- Doubt as to Collectability (DATC);
- Effective Tax Administration (ETA).

Factors considered in determining eligibility:

- Ability to pay;
- Income;
- Expenses; and
- Asset equity.

Pairs well with bankruptcy when:

- Chapter 13 debtor cannot reasonably afford a Plan when required to pay full tax debt.
- Chapter 7 debtor has significant non-dischargeable tax debt.

Warning:

- OICs are uncommon due to stringent requirements.
- IRS will not consider an OIC while in active bankruptcy.
- OICs are considered executory contracts. If a debtor intends to assume the OIC, you must properly assume the OIC.

C. Payment Plans

Guaranteed Installment Agreement:

- **OVERVIEW:** Individual taxpayers who owe up to **\$10,000** can pay through monthly direct debit payments for up to **36 months (3 years)**. While the IRS generally will not require a financial statement, they may need some financial information from the taxpayer.
- **REQUIREMENTS:** In order to apply for the program, you must be in tax compliance. This means that you have filed at least the past six years of returns and made any required estimated tax payments (if applicable).
- **LIENS:** If a taxpayer requests a guaranteed installment agreement prior to Federal Tax Liens being filed, the IRS will not file a lien unless the taxpayer defaults the agreement in the future. If a lien has already been filed, a taxpayer may request to remove the lien once 3 direct debit installment agreement payments have been made. Taxpayers also need to request this in writing.

Streamlined Installment Agreement (72 mo. repayment) (Fresh Start):

- **OVERVIEW:** Individual taxpayers who owe up to **\$50,000** can pay through monthly direct debit payments for up to **72 months (6 years)**. While the IRS generally will not require a financial statement, they may need some financial information from the taxpayer.
- **REQUIREMENTS:** In order to apply for the program, you must be in tax compliance. This means that you have filed at least the past six years of returns and made any required estimated tax payments (if applicable).

- **LIENS:** If a taxpayer requests a streamline agreement prior to Federal Tax Liens being filed, the IRS will not file a lien unless the taxpayer defaults the agreement in the future. If a lien has already been filed, a taxpayer may request to remove the lien once the total account balance is under \$25,000 and 3 direct debit installment agreement payments. Taxpayers also need to request this in writing.

84 Month Installment Agreement:

- **OVERVIEW:** The IRS pilot program allows individual taxpayers with an assessed balance of tax, penalty and interest **between \$50,000 and \$100,000** to enter into a direct debit installment agreement for up to **84 months (7 years)**. While the IRS generally will not require a financial statement, they may need some financial information from the taxpayer such as bank account information to set up the direct debit agreement.
- **REQUIREMENTS:** In order to apply for the program, you must be in tax compliance. This means that you have filed at least the past six years of returns and made any required estimated tax payments (if applicable).
- **LIENS:** Federal Tax Liens can be filed under this program.

Pairs well with bankruptcy when:

- A Chapter 7 debtor with non-dischargeable tax debt wishes to file a bankruptcy now and pay the non-dischargeable tax debt over time.
- An installment agreement can be used to prevent a lien from being filed or to remove a lien in advance of bankruptcy.
- Installment agreements can give a taxpayer time to prepare for bankruptcy. This may be particularly important where a taxpayer is attempting to wait for a dischargeability deadline before filing a bankruptcy petition.

D. Financial Hardship

Generally, two types of financial hardship plans:

- **Currently Not Collectable (CNC)**
The IRS is granted the authority to determine that some accounts are CNC.
The IRS balances the potential for collection against the costs and its ability to collect.
This is basically used in conjunction with waiting out the CSED date.
- **Partial Pay Installment Agreements:**
Allows a taxpayer to pay less than the full amount of debt.
Payments are structured to allow the taxpayer to afford the payments.
More stringent financial analysis is required than a standard installment agreement.
Often referred to as the “backdoor OIC”s.

Pairs well with bankruptcy when:

- A Chapter 7 debtor with limited income/assets has a non-dischargeable tax debt. Debtor can obtain a discharge and obtain CNC status. This would free the debtor from IRS collection tactics despite the presence of a tax debt.
- If a debtor is nearing a CSED date, a PPIA or CNC can be used to allow the debtor to reach CSED. This may be most useful if there is a lien that is about to expire.

NOTE: New liens can be filed if the taxpayer is within the CSED.

E. Wage Garnishment/Levy Releases

- **The IRS is required to release a levy if you meet any one of the following:**
 - You paid the amount you owe,
 - Releasing the levy will help you pay your taxes,
 - You enter into an Installment Agreement and the terms of the agreement don't allow for the levy to continue,
 - The levy creates an economic hardship, meaning the IRS has determined the levy prevents you from meeting basic, reasonable living expenses, or
 - The value of the property is more than the amount owed and releasing the levy will not hinder the ability of the IRS to collect the amount owed.

Pairs well with bankruptcy when:

- This is actually duplicative of the relief you obtain in bankruptcy. Bankruptcy discontinues levies and garnishments. This is included more to show non-bankruptcy relief for levies/garnishments.
- You may be able to use non-bankruptcy levy/garnishment releases in order to wait out a dischargeability date.

F. Federal Tax Lien Releases

Federal Tax Liens can be resolved in a number of ways:

- Discharged – Removed from a specific piece of property. This would allow a piece of property to be sold for example.
- Subordinated – Allows a taxpayer to borrow from encumbered property such as allowing refinancing of a mortgage or adding a home equity loan.
- Withdrawn – This is a complete removal of a tax lien.

Pairs well with bankruptcy when:

- Most useful when a Chapter 13 debtor has a substantial secured tax debt that would be otherwise dischargeable. Having the lien withdrawn would remove the IRS's security interest and would make the debt unsecured.

V. Pre-Bankruptcy Planning

When a debtor has a tax issue, proper planning is essential:

- Obtain tax account transcripts
- Determine dischargeability issues
- Determine lien issues
- Determine compliance
- Check debtor's withholdings

Failure to properly plan can be disastrous:

- Hugger v. Lawrence J. Warfield et al.; No. AZ-18-1003 (April 5, 2019)
 - Mr. Hugger filed a chapter 7 bankruptcy case and received his discharge in May of 2017 before coming to the realization that he had filed too early to obtain a discharge of his tax debts.
 - After the epiphany in September of 2017, he requested that the bankruptcy court vacate his discharge and dismiss the chapter 7 case.
 - The Court denied the request to dismiss the Chapter 7, rendering the taxes non-dischargeable.
 - The case points to the critical importance of understanding tax transcripts and properly counting days in order to maximize the benefits of a bankruptcy filing.

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Chapter Eight

**“Debt Relief Agency” and Incurring Debt and Advertising
under BAPCPA**

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“Debt Relief Agency” and Incurring Debt and Advertising under BAPCPA

I. *Milavetz, Gallop & Milavetz, P.A. v. United States*, 130 S.Ct. 1324 (2010)

This case was initiated by a Bankruptcy firm along with a couple of its clients who brought a suit against the United States seeking a declaratory judgment that the new provisions in the Bankruptcy Abuse Prevention and Consumer Protection Act (**BAPCPA**)¹ did not apply to attorneys and law firms and were unconstitutional as applied to attorneys.

The Plaintiffs attempted to argue that the definition of a “debt relief agency” (**DRA**) in 11 USC § 101(12A)² did not expressly include “attorneys.” Plaintiffs further argued that the provisions of 11 U.S.C. § 523(a)(4)³ is impermissibly vague. Finally, Plaintiffs argued that 11 U.S.C. § 528’s disclosure requirements were essentially unconstitutional as limiting freedom of speech.

In *Milavets*, Supreme Court Justice Sotomayor gave an opinion outlining three important holdings for Bankruptcy Practitioners:

1. An Attorney providing Bankruptcy assistance **is** in fact considered a “debt relief agency” as defined under BAPCPA;

¹ BAPCPA came about in 2005 and, among other things, amended federal law to impose new requirements and prohibitions on professionals who assist with the preparation of Bankruptcy petitions, and to correct perceived abuses of the bankruptcy system.

² The term “debt relief agency” means any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer under section 110, but does not include--

(A) any person who is an officer, director, employee, or agent of a person who provides such assistance or of the bankruptcy petition preparer;

(B) a nonprofit organization that is exempt from taxation under section 501(c)(3) of the Internal Revenue Code of 1986;

(C) a creditor of such assisted person, to the extent that the creditor is assisting such assisted person to restructure any debt owed by such assisted person to the creditor;

(D) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act) or any Federal credit union or State credit union (as those terms are defined in section 101 of the Federal Credit Union Act), or any affiliate or subsidiary of such depository institution or credit union; or

(E) an author, publisher, distributor, or seller of works subject to copyright protection under title 17, when acting in such capacity.

11 U.S.C. § 101(12A).

³ (a) A debt relief agency shall not...(4) advise an assisted person or prospective assisted person to incur more debt in contemplation of such person filing a case under this title or to pay an attorney or bankruptcy petition preparer a fee or charge for services performed as part of preparing for or representing a debtor in a case under this title.

11 U.S.C. § 523(a)(4).

2. § 526(a)(4) which prohibits a DRA from advising clients to incur more debt in contemplation of Bankruptcy **only prohibits advice to incur more debt when the “impelling reason” for the advice is anticipation of bankruptcy**; and
3. That § 528, which imposes advertising disclosure requirements on DRAs, is reasonably related to the government’s interest in preventing consumer deception and therefore valid.

The 11th Circuit last year took another look at § 526(a)(4) and the *Milavets* decision and specifically held that an attorney violates Section 526(a)(4) if instructing a client to pay his bankruptcy-related legal fees using a credit card. *Cadwell v. Kaufman, Englett & Lynd, PLLC*, 886 F.3d 1153, 1155 (11th Cir. 2018).

Practical TIP #1: Take cash, check, or debit card!

Practical TIP #2: Do not advise clients to “load up” on debt with the expectation of obtaining a discharge.

Practical TIP #3: Make sure your advertisements include a disclosure that you are a “debt relief agency”.

II. Good Faith Requirement for Filing

In re Tamecki, 229 F.3d 205 (3d Cir. 2000)

In re Tamecki was a Third Circuit case which dealt with the good faith requirement for a Chapter 7 filing.

Ronald Tamecki filed a Chapter 7 Petition after seven years of separation from his wife and while a divorce was pending. Over \$100,000.00 in equity existed in the home co-owned with his wife. He sought to discharge a credit card debt to MBNA America in the amount of \$35,000.00.

This author filed a motion to dismiss for lack of good faith, believing that the divorce was soon to be finalized and that the Debtor would receive enough at the sale of the real estate to pay the credit card debt in full and have enough left over for a fresh start.

The Bankruptcy Court agreed, and the District Court and Third Circuit affirmed. At the oral argument, much was made about the lack of a specific requirement in the Chapter 7 portion of the Bankruptcy Code about filing in good faith. In a 2-1 decision (Judge Rendell dissenting), the Court found that good faith was a prerequisite in every Chapter 7 filing.

III. Inherited IRAs

Clark v. Rameker, 134 S. Ct. 2242 (2014)

Pursuant to 11 U.S.C. § 522(b)(3)(C), Debtors may exempt “retirement funds” from the Bankruptcy Estate. A reading of § 522 reveals that the exemptions are granted to retirement funds held in accounts exempt from taxation under certain sections of the Internal Revenue Code. This case discusses the differences between traditional IRAs, Roth IRAs, and inherited IRAs.

In *Clark v. Rameker*, the Supreme Court resolved a Circuit split and ruled unanimously that inherited IRAs are not shielded from creditors in bankruptcy proceedings and are not considered “retirement funds” within the meaning of 11 U.S.C. § 522(b)(3)(C). Justice Sotomayor delivered the unanimous opinion highlighting the following characteristics which remove inherited IRAs from the definition of “retirement funds”:

1. Holders of inherited IRAs may never invest additional money in the account;
2. Holders of inherited IRAs are required to withdraw money from the accounts, no matter how far they are from retirement; and
3. Holders of an inherited IRA may withdraw the entire balance of the account at any time—and use it for any purpose—without penalty.

In *Clark*, the Debtors filed a Chapter 7 and identified an inherited IRA worth about \$300,000 that the wife had received from her late mother almost 10-years prior to the filing of the Bankruptcy in an amount exceeding \$450,000. The Trustee and unsecured creditors objected to the claimed exemption. Debtors argued that the inherited funds *were* retirement funds because they were actually set aside for retirement, that the initial owner intended the funds be for retirement purposes, and because there is a possibility that the holder of the inherited funds *can* leave the inherited IRA intact until retirement while taking only the minimum required distributions. Justice Sotomayor stated in response:

Under petitioners' contrary logic, if an individual withdraws money from a traditional IRA and gives it to a friend who then deposits it into a checking account, that money should be forever deemed “retirement funds” because it was originally set aside for retirement. That is plainly incorrect.

Id. at 2248. Further, Debtors argued that various sections of § 522 reference “Debtor’s interest” in certain assets being exempt. However, Section 522(b)(3)(C)'s retirement funds exemption, by contrast, includes no such reference, and the Court determined that the “Debtor’s interest” language was placed by Congress with the intention of

distinguishing a limit on the value of a particular asset, not to distinguish between Debtors' assets and the assets of another person.

IV. **Valuation and Exemption of Bankruptcy Estate Assets**

***Schwab v. Reilly*, 560 U.S. 770, 130 S. Ct. 2652 (2010)**

Schwab v. Reilly was a U.S. Supreme Court case which dealt with the proper amount of exemption that an individual can take in personal property.

The Debtor filed a Chapter 7 proceeding and listed equipment related to her catering business as exempt from the bankruptcy proceeding, valuing the equipment at over \$10,000.00. The trustee had the business equipment appraised at over \$17,000.00. He then filed a motion to sell the equipment, pay the Debtor her exemption, and pay the rest to creditors. The Debtor objected to the sale, arguing that the equipment had become fully exempt when the trustee failed to object when she listed the equipment as exempt. The Bankruptcy Court agreed with the Debtor, as did the District Court and the Third Circuit Court of Appeals.

The Supreme Court held that the trustee or a creditor is not required to object to a debtor's exemption in order to preserve the right to claim any value in the item exceeding the value listed as exempt. The Court reasoned that the Bankruptcy Code only requires a timely objection to an asset's categorization as exempt and does not apply to objections about the asset's value.

The boxes on the amended form "C" allow debtors to choose either a specific dollar amount for each item of property or market value up to the amount of allowable statutory exemption. In the author's experience as trustee, this has eliminated some confusion as to what exactly is being claimed as exempt.

V. **11 U.S.C. § 523(a) Exceptions to Discharge – Actual Fraud**

***Husky Int'l Elecs., Inc. v. Ritz*, 136 S. Ct. 1581 (2016)**

In *Husky Int'l Elecs., Inc. v. Ritz*, the Supreme Court held that the term "actual fraud" in 11 U.S.C. § 523(a)(2)(A)⁴ encompasses forms of fraud, like fraudulent conveyance schemes, even when those schemes do not involve a false representation.

⁴ "(a) A discharge under [section 727](#), [1141](#), [1228\(a\)](#), [1228\(b\)](#), or [1328\(b\)](#) of this title does not discharge an individual debtor from any debt-- (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by-- (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;" 11 U.S.C. § 523(a)(2)(A).

Chrysalis Manufacturing Corp. incurred a debt to Plaintiff Husky International Electronics, Inc. in the amount of approximately \$164,000 resulting from Chrysalis's purchase of electronic device components. The Director and part owner of Chrysalis transferred large sums of money to other entities he controlled prior to filing an individual Chapter 7 Bankruptcy for himself. Husky filed a Complaint for nondischargeability, seeking to hold the Debtor individually liable for Chrysalis's debt. The District Court (Texas) and the 5th Circuit held that the Debtor was liable under state law, but because no "actual fraud" existed, the debt would be dischargeable because the Debtor made no "false representations" to Husky regarding the transfer of Chrysalis' assets. The Supreme Court reversed and remanded.

The Supreme Court looked to the historical meaning of "actual fraud" quoting an old Supreme Court case, *Neal v. Clark*, 95 U.S. 704, 709 (1877), which determined that "actual fraud" meant fraud committed with wrongful intent. Additionally, Justice Sotomayor pointed out that the term "fraud" has, since the beginnings of bankruptcy practice, been used to describe asset transfers that, like the scheme in *Husky Int'l*, impair a creditor's ability to collect a debt.

The concept dates back to one of the first Bankruptcy Acts called "the Fraudulent Conveyances Act of 1571", an Act of Parliament in England. This definition is deeply embedded in our modern fraud-related laws and after *Husky*, no longer requires an actual representation by the Debtor, but simply a scheme to defraud.

A recent Eastern District case concluded that a claim for "deepening insolvency"⁵ is further bolstered by the Supreme Court's decision in *Husky*, which evidences a jurisprudential trend towards a broadened conception of "fraud" and therefore supports a finding that a fraudulent conveyance can be the basis for a deepening insolvency claim. *Impala Platinum Holdings Ltd. v. A-1 Specialized Servs. & Supplies, Inc.*, No. CV 16-1343, 2017 WL 877311, at *6 (E.D. Pa. Mar. 3, 2017).

Practical TIP #1: No transfers of assets from the Debtor to family, friends, or associates! The time period is determined by state - in PA, the lookback is 4-years under the *Pennsylvania Uniform Fraudulent Transfer Act*.

⁵ To establish a claim for deepening insolvency, the plaintiff must show "an injury to [a debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." [Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347 \(3d Cir. 2001\)](#). As stated in Lafferty, and reiterated in [In re CitX Corp., Inc., 448 F.3d 672 \(3d Cir. 2006\)](#), the plaintiff must allege fraudulent, not merely negligent, conduct led to the company's worsened financial state. See [Lafferty, 267 F.3d at 349](#); [CitX Corp., Inc., 448 F.3d at 681](#).

VI. Right to Jury Trial in Preference and Fraudulent Transfer Actions

Katchen v. Landy, 382 U.S. 323, 86 S. Ct. 467, (1966) and *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 109 S. Ct. 2782, 106 L. Ed. 2d 26 (1989)

These two U.S. Supreme Court cases discuss the right to a jury trial in preference and fraudulent transfer actions in a bankruptcy setting.

Katchen v. Landy, 382 U.S. 323 (1966) held that a creditor was not entitled to a jury trial in a preference action when it filed a Proof of Claim because it subjected itself to the jurisdiction of the Bankruptcy Court and converted a legal claim to an equitable one.

Gran Financiera v. Nordberg, 492 U.S. 33 (1989), a Bankruptcy Code case, held that the same principle applies in a fraudulent transfer action. *Langenkamp v. Culp*, 498 U.S. 42 (1990), also a Bankruptcy Code case, held that the above principle still applied in a preference suit as a Bankruptcy Code case.

Takeaway: If you see a preference or fraudulent transfer action coming against your client and are desirous of a jury trial on the merits, expect that the filing of a Proof of Claim will subject your client to the jurisdiction of the Bankruptcy Court and will act as a waiver of jury trial rights.

VII. 11 U.S.C. § 523(a) Exceptions to Discharge – False Statement About One Asset Must be In Writing to Render Debt Nondischargeable under § 523(a)(2)

Lamar, Archer & Cofrin, LLP v. Appling, 138 S. Ct. 1752 (2018)

In *Lamar* in 2018, the Supreme Court resolved a Circuit split by holding that a false statement about a single asset must be in writing to provide grounds for rendering a debt nondischargeable under 11 U.S.C. § 523(a)(2)(B).

In *Lamar*, Plaintiff is a law firm and the Defendant/Debtor was their client. The client told the firm that he would pay delinquent and future legal fees in a litigation matter with his tax refund, and based on this statement, the law firm agreed to continue representation. However, the Debtor's tax refund was much less than he stated it would be, and he used it for business expenses. After spending the money, he told the law firm he was still waiting to receive the tax refund and the firm completed pending litigation for the client and a final invoice was sent. The invoice was not paid, and the law firm sued him and obtained a judgment. Debtor then filed a Chapter 7 Bankruptcy.

Plaintiff filed an Adversary Proceeding in the Ch. 7 arguing that the debt was nondischargeable pursuant to 11 U.S.C. § 523(a)(2)(A), which bars discharge of specified debts arising from "false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's ... financial condition." However, (a)(2)(A) does not

include statements respecting financial condition, so this situation actually fell under § 523(a)(2)(B) which states:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt-- (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(B) use of a statement in writing--

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive

The Supreme Court focused on the term “respecting” in § 523(a)(2) referencing *Kleppe v. New Mexico*, 96 S.Ct. 2285 (1976), in which it determined that the use of the word “respecting” in a legal context generally has a broadening effect, ensuring that the scope of a provision covers not only its subject but also matters relating to that subject. Had Congress intended § 523(a)(2)(B) to encompass only statements expressing the balance of a debtor's assets and liabilities, there are several ways in which it could have so specified, e.g., “statement disclosing the debtor's financial condition” or “statement of the debtor's financial condition.” But Congress did not use such narrow language. The Court pointed out that creditors are not powerless because...

...Practical Tip for CREDITORS: GET IT IN WRITING!

VIII. Absolute Priority Rule in Ch. 11

Case v. Los Angeles Lumber Prod. Co., 308 U.S. 106, 60 S. Ct. 1 (1939) and *Bank of Am. Nat. Tr. & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 119 S. Ct. 1411, (1999)

These two cases discussed a very important concept known as the absolute priority rule in Chapter 11 cases.

In *Case*, the Plan of Reorganization submitted by the Debtor provided that a new corporation would be formed and would acquire the subsidiary's assets. Certain stockholders would receive stock in the new corporation without needing to make any new contribution.

Bondholders objected to the plan on the grounds that it gave old stockholders 23 percent of the assets and voting power in the new company, even though the stockholders did not make any new contribution.

The Bankruptcy Court confirmed the plan, and the District Court and Circuit Court both confirmed, but the Supreme Court reversed, finding that the plan was not “fair and equitable” because it violated the “rule of full or absolute priority”.

The fact that the plan had overwhelming creditor support was not significant according to the Court. The Court cited previous Supreme Court case law providing the principle that the stockholders interest in the property was subordinate to the rights of creditors, first of secured, and then of unsecured.

The Court made it clear that intangible benefits allegedly provided by old stockholders do not qualify as added value for the purpose of confirming plan.

The Court noted in dicta that stockholders could participate in a plan and receive new equity if they contributed new capital. This principle has become known as “new value corollary”.

This case was decided under the Bankruptcy Act which allowed any creditor to invoke the rule. Under the Bankruptcy Code, there must be a dissenting class of creditors to invoke the rule. 11 USC §1129(b).

The Supreme Court addressed the issue of absolute priority in *Bank of America National Trust & Savings Association v. 203 N. Lasalle Street Partnership*, 526 U.S. 434 (1999), in which the Court noted that some courts applied the new value corollary, but the Court did not accept or reject the corollary. Instead, the Court held that a plan violates §1129(b) if it provides that only old equity holders are given the opportunity to purchase new equity. The Court did not specify the method but made it clear that the old equity holders must pay market rate for the new equity and that the best way to ensure such market valuation is to expose the interests to the market – that is, to allow competing parties a chance to purchase the equity.

Takeaway for private practitioners:

1. Don't assume that your plan will satisfy the absolute priority rule by the stockholders retaining the stock in an insolvent corporation without paying anything for it.
2. Will forgiving debt owed to the principal as a creditor satisfy the absolute priority rule?
3. Put to the test, how do the current stockholders allow competitive bidding? Is it satisfactory to allow other stockholders and creditors the opportunity to outbid the amount of money proposed to be put in as a capital contribution? Is it necessary to advertise outside the confines of the bankruptcy case by placing an ad in a national or regional publication?

IX. Structured Dismissals and Priority Rules in Ch. 11

Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 197 L. Ed. 2d 398 (2017)

In resolving Chapter 11 cases, there are generally three possible outcomes: (1) negotiating a plan to distribute the value of the Bankruptcy Estate; (2) convert to Chapter 7 for liquidation of the assets and distribution to creditors; or (3) dismissal, at which time the Court may order what is called a “structured dismissal” under 11 U.S.C. § 349 attempting to restore the status quo prior to the filing of the Chapter 11.

In *Czyzewski*, the Supreme Court reversing a 3rd Circuit decision held that a bankruptcy court may not approve a structured dismissal of a Chapter 11 case that provides for distributions that do not follow the Bankruptcy Code's ordinary priority rules without the affected creditors' consent.

In *Czyzewski*, Jevic Transportation filed for Chapter 11 bankruptcy after being purchased in a leveraged buyout. The bankruptcy prompted two lawsuits. In the first, former employees were awarded judgment against Jevic. Part of that judgment counted as a priority wage claim under 11 U.S.C. § 507(a)(4), entitling the workers to payment ahead of general unsecured claims.

In the second suit, unsecured creditors sued the purchasers of Jevic for fraudulent conveyance in connection with the leveraged buyout. These parties to the second suit negotiated a settlement agreement that called for a structured dismissal of Jevic's Chapter 11 bankruptcy. Under the proposed structured dismissal, the employees holding priority wage claims would receive nothing, but lower-priority general unsecured creditors would be paid.

Although this distribution scheme violated the Code's priority rules by paying general unsecured claims ahead of priority claims, the Bankruptcy Court nevertheless approved the settlement agreement and dismissed the case. The Bankruptcy Court reasoned that because the proposed payouts would occur pursuant to a structured dismissal rather than an approved plan, the failure to follow ordinary priority rules did not bar approval. The Third Circuit held that it was permissible in “rare cases” in which courts could find “sufficient reasons” to disregard priority. The Supreme Court eventually disagreed stating, “The Code gives a bankruptcy court the power to “dismiss” a Chapter 11 case. 11 U.S.C. § 1112(b). But the word “dismiss” itself says nothing about the power to make nonconsensual priority-violating distributions of estate value.” *Czyzewski*, at 984. It also went on to point out that having a “rare case” exception could open the floodgates and set a dangerous precedent for Debtors and their favored creditors.

X. Good Faith Sales

In re Abbotts Dairies of Pennsylvania, Inc., 788 F.2d 143 (3d Cir. 1986)

Abbotts Dairies of Pennsylvania, Inc., et al. was a Third Circuit case which spelled out conditions on what constitutes a good faith sale in a bankruptcy case.

Abbotts Dairies and its related entities filed Chapter 11 Petitions, and on the same date filed motions for approval of two agreements for sale of its assets to ADC. The Bankruptcy Court held an emergency hearing, and at a subsequent hearing approved the sale, due in large part to the claimed emergency need due to the large, ongoing losses.

The Bankruptcy Court disallowed certain conditions and competitive bids and refused to allow witness testimony requested by an objecting creditor. The District Court affirmed, but the Third Circuit reversed.

The Third Circuit had numerous concerns regarding the process by which the sale was conducted and approved.

First, there was no appraisal of the assets proposed to be sold. Had there been an appraisal, the court cited with approval *Rock Indus. Mach. Corp.*, 572 F.2d at 1197 n. 1. for the proposition that a sale for 75% of the appraised value is fair consideration.

Secondly, the principal of the Debtor had an agreement with the purchaser to act as “consultant” during the pendency of the bankruptcy proceeding at a salary of \$150,000.00 per year and conditioned on the Bankruptcy Court approving the sale and had been offered a permanent position as well. This did not appear in the sale motion or notice to creditors.

Next, no disclosure statement and plan had been filed, with all the typical financial information normally available to the creditors to enable them to make an informed decision. Also, the Bankruptcy Court did not make an explicit finding of good faith on the part of the purchaser throughout the sale proceedings.

The suggestion in its opinion was there was at least a potential in the case for a “contrived emergency” orchestrated by ADC and Abbotts. The situation, according to the Court, was ripe for collusion and self-dealing.

The takeaways on this case for private practitioners are:

1. Secure an appraisal by an objective, independent appraiser not aligned with the seller or buyer;
2. If the sale is to an insider or if there is an agreement for the seller’s principal to be employed by the buyer, as in *Abbotts*, then disclose that in the notice to creditors;
3. If you have time, prepare a disclosure statement and plan setting forth the proposed sale. There will be much more financial information than in a sale

motion; and

4. Don't wait to file the sale motion until it becomes an emergency. The bankruptcy judge you have is not necessarily going to accommodate the Debtor as in Abbots.

Chapter Nine

Everything a Secured Creditor Should Know About Chapter 11

Hon. Henry W. Van Eck
US Bankruptcy Court for the Middle District of PA
Wilkes Barre

EVERYTHING A SECURED CREDITOR SHOULD KNOW ABOUT CHAPTER 11

I. INTRODUCTION

Who is the secured creditor? A secured creditor may be the holder of a statutory lien, an equipment lender, a receivables lender, a bank with a lien on all assets, a holder of a real estate mortgage or any number of other types of entities. It may be a subordinate lender or a senior lender. It may be under-secured, fully secured or over-secured. It may possess a single, relatively new loan with the debtor, or it may have a long-term business relationship with the debtor and/or its principals. The loan may be a minor matter or a big deal for the lender. As such, there is no single perspective for the secured creditor. Even among secured lenders, where you stand in the case is purely a function of where you sit, and one secured lender may sit in a very different place than another.

Notwithstanding the absence of a single perspective equally applicable to all secured creditors, there are some concerns that are common to most, if not all, secured lenders. This presentation is devoted to addressing these common concerns.

II. COMMON CONCERNS

A. CAN THE DEBTOR USE A SECURED CREDITOR'S COLLATERAL DURING THE CASE?

Typically, the debtor is allowed to use a secured lender's collateral during a Chapter 11 case. For example, if the creditor has a mortgage lien on a professional building or a security interest in equipment, the debtor will be permitted to use the collateral, even if the secured loan is in default. However, as discussed more fully below, under certain circumstances, a secured creditor may be entitled to compensation for any loss of value resulting from the continued use.

There are special rules if a lender has a security interest in "cash collateral," as defined by 11 USC §363(a). Cash, negotiable instruments, deposit accounts or other cash equivalents in which the debtor and an entity other than the debtor have an interest are included in the definition of "cash collateral".¹ Further, section 363 specifically includes the "proceeds, products, offspring, rents, or profits of property . . . whether existing before or after the commencement of a case . . .".² Under these conditions, a debtor must have the secured creditor's consent or a court order before it can use the cash collateral.

It is not uncommon for a debtor to need immediate access to cash collateral at the time of the petition. Typically, the debtor will file an "Emergency Motion for Authority to Use Cash Collateral" as one of its first-day motions. Many times, the secured creditor will use this opportunity to negotiate and obtain certain rights or concessions from the debtor in exchange for its consent to the use of cash collateral. Assuming an agreement is reached, and that such agreement does not appear unreasonable to the

¹ See 11 USC §363(a).

² 11 USC §363(a).

judge or prohibited by other provisions of the Bankruptcy Code, a stipulated order reflecting the parties' agreement will be filed.

Other times, however the parties are unable to reach an understanding and a contested hearing will be held to determine if the debtor has the right to use the cash collateral. During a contested cash collateral hearing, the secured creditor must first establish that the collateral at issue is in fact "cash collateral". Typically, this is not a difficult burden to meet. Once this burden has been met by the creditor, the debtor must establish that it can provide "adequate protection" to the creditor in order to obtain permission from the court to use the cash collateral. The next and most obvious question, therefore is "what is adequate protection"?

Adequate protection is not defined in the Bankruptcy Code. However, § 361 provides three non-exclusive methods as examples: (1) periodic cash payments; (2) additional or replacement liens; or (3) other relief resulting in the "indubitable equivalent" of the secured creditor's interest. Exactly which form of adequate protection is appropriate depends upon, among other things, (1) how great the risk is to the secured lender, (2) what the cash collateral is being used for, and (3) what types of protection the debtor is able to offer.

By way of example, assume the primary collateral is accounts receivable. Under these circumstances, it is common for the lender to be granted a "replacement lien" on receivables that are generated post-petition. This form of protection is adequate because §552 of the bankruptcy code, subject to certain exceptions, generally prevents a pre-petition lien from attaching to post-petition receivables. Pursuant to this arrangement, the debtor spends the proceeds of the receivables that are subject to the lenders pre-petition lien in exchange for offering a lien on the new "replacement" (post-petition) receivables. As long as the debtor continues to generate post-petition receivables at the same rate that it spends the proceeds of the pre-petition receivables, then the secured creditor will be adequately protected for the debtor's use of its cash collateral.

But what if the debtor is using proceeds of "hard collateral", such as rents, to preserve the hard collateral itself, such as an apartment building? Sometimes this arrangement is considered adequate protection because the maintenance and upkeep of the hard collateral benefits the secured creditor as a lien holder. Likewise, if an equity cushion exists, where the value of the hard collateral substantially exceeds the amount of the secured debt, then the secured creditor may be deemed to be adequately protected, assuming the equity cushion is material. The principle underlying this concept is that if the value of the collateral substantially exceeds the debt owed on it, then the use of the collateral is unlikely to present an unfair risk to the secured creditor. Valuation of the collateral is therefore critical to the determination of adequate protection.

There are certain arrangements that are expressly forbidden as adequate protection. Specifically, §361(3) specifically prohibits granting an administrative priority claim to the extent of any diminishing in collateral value to a secured creditor as adequate protection. However, §507(b) grants the secured creditor a "super-priority" administrative claim in the event that the adequate protection offered proves to be insufficient to compensate it for the loss of its interest in collateral during the case. A

super-priority administrative claim gives the secured creditor priority over other regular administrative claimants, and acts as a fallback provision to protect the secured creditor.

B. WHAT HAPPENS IF THE COLLATERAL DECREASES IN VALUE DURING THE CASE?

The value of collateral might diminish during the course of the bankruptcy case for several reasons. One reason for diminution may simply be a function of the market. If the collateral is securities, for example, this is not uncommon. A more typical reason, however, is a decrease in value resulting from the debtor's use of that collateral. If your collateral is a new car, for example, and the debtor drives the car during the case for year and puts 15,000 new miles on it, then the value of the collateral will almost certainly be diminished.

The risk to the value of collateral is of particular concern to a secured creditor because, as more fully discussed below, the secured creditor is generally precluded from repossessing its collateral during the case. Does that mean that a creditor must sit by and watch the value of its collateral erode? Not exactly. The Bankruptcy Code recognizes that a secured creditor may be entitled to adequate protection for the loss of the value of its interest in collateral from the date of the petition until the confirmation of the chapter 11 plan, or conversion or dismissal of the case, whichever occurs first.

The concept of adequate protection as described above, and as it relates to the debtor's ability to use cash collateral, also applies in the event that the value of other (non-cash) collateral should decline. Section 363(e) provides that "at any time, on request of an entity that has an interest in property used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest." Similarly, section 362(d)(1) of Code allows the court to grant relief from the automatic stay to a secured creditor, allowing it to exercise its remedies against the collateral, if the debtor is unable to provide adequate protection. However, it is not the responsibility of the court to monitor the value of the secured creditor's collateral to ensure that it is adequately protected. Nor should a secured creditor rely upon the debtor to offer adequate protection. To the contrary, the debtor often fails to offer adequate protection or to seek an order from the court granting it authority to use the collateral. As such, if a secured creditor believes that its collateral is declining in value post-petition, it is the responsibility of that secured creditor to file a motion for adequate protection, or for relief from the automatic stay, in order to trigger consideration of the issue by the court.

Two additional points are worth noting here. First, secured creditors do not get compensation for the delay caused by the automatic stay, even if it can be demonstrated that it is imposing a real inconvenience. Stated another way, the mere fact that the automatic stay operates to delay a creditor's ability to exercise its remedies against the collateral (or the debtor) is not sufficient to justify an award of adequate protection. The automatic stay causes inconvenience for all creditors. The need for adequate protection is triggered by establishing that the creditor is suffering a post-petition decline in the value of its collateral. Second, a significantly over-secured creditor is unlikely to get adequate protection, even if its collateral value is shown to be diminishing. The margin between the value of the collateral and the amount of the outstanding debt is often referred to as the "equity cushion". Courts frequently deny

the request for adequate protection where a significant equity cushion exists. However, as the value of the collateral approaches the level of the debt it secures, the prospects for adequate protection improve. It is worth noting that you do not have to wait until you are under-secured to ask for, or receive, adequate protection.

Finally, valuation of the collateral is a critical first step in determining whether a secured creditor is entitled to adequate protection. Sometimes the value of your collateral is clear, as in the case of shares of a public company or a foreign currency amount. However, if your collateral is a farm, business facility, apartment complex or other improved real property, you will probably need the expert testimony of an appraiser to establish the collateral value. In the absence of a valuation of the collateral, it is all but impossible for the court to make a determination of the need or sufficiency of adequate protection.

C. CAN A SECURED CREDITOR FORECLOSE ON ITS COLLATERAL DURING THE CASE?

As indicated above, Section 362 of the Bankruptcy Code imposes the automatic stay. The automatic stay generally prohibits any action by a secured creditor to recover or foreclose on its collateral during the bankruptcy case. Section 362(b) does provide certain narrow exceptions to the automatic stay. However, if you are just a regular secured creditor who wants to foreclose on its collateral, it is unlikely that you will find an applicable exception. After all, one of the main benefits of Chapter 11 is to give the debtor some breathing room to formulate a plan of reorganization so it can continue to operate and reorganize. If every secured creditor was allowed to foreclose and its collateral, there would not be much breathing room and the likelihood for a Debtor to emerge successfully from bankruptcy would be slim. That means that it is unlikely that you will be able to foreclose on your collateral, even if your loan is in default at the time the Debtor files its petition.

However, Section 362(d) does provide a few opportunities for relief from the automatic stay. To obtain this relief, you must file a "Motion for Relief from the Automatic Stay", which is a contested matter pursuant to bankruptcy rule 9014. Section 362(e) requires prompt consideration by the court of all motions for relief, and many are resolved within 30 days. However, the same section provides for many opportunities to extend the matter well beyond 30 days.

The first ground for relief from the stay is "cause, including lack of adequate protection." If the court finds that the creditor is entitled to adequate protection, but the debtor does not provide it, then the creditor is entitled to relief from the stay. Although this provision suggests additional causes justifying relief from the stay, it fails to specifically enumerate any additional bases for demonstrating "cause." This ambiguity gives bankruptcy judges a lot of discretion. As a general matter, it is safe to say that courts tend to balance the harm imposed upon a secured creditor by continuing the stay against the benefit of the stay to the debtor, with the presumption (usually) in favor of the debtor.

The second ground for relief from the stay is satisfied if (1) there is no equity in the property; and (2) the property is "not necessary to an effective reorganization." The first element of this test means that the debt secured by liens on the property exceeds the fair market value of the property. The second element means that the debtor can successfully reorganize without the use of this property. Both elements

must be satisfied to obtain relief from the stay. The burden of proof rests with the secured creditor regarding the first element. By contrast, the burden rests with the debtor regarding the second.

The third ground for relief from the stay is applicable in single-asset real estate cases only. Stay relief can be granted unless the debtor has filed a plan of reorganization that has a "reasonable possibility of being confirmed with any reasonable time" or, alternatively, the debtor has commenced monthly payments in "an amount equal to interest at the then applicable non-default contract rate of interest on the value of the creditor's interest". If you are involved in a single asset real estate case, you should examine §362(d)(3) carefully.

Finally, the fourth ground for relief from the stay involves creditors whose claims are secured by an interest in real property where the court finds that the bankruptcy filing "was part of a scheme to delay, hinder, or defraud creditors that involved" (1) transfer of ownership in the real property without the consent of the secured creditor or court approval; or (2) multiple bankruptcy filings affecting such real property.

D. WILL THE SECURED CREDITOR CONTINUE TO GET INTEREST OR OTHER PAYMENTS DURING THE CASE?

Secured creditors, even if they are over-secured, usually do not receive principal payments during the case. This is true even if payments are due under the terms of the loan or if the loan matures during the case. However, if the creditor is over-secured, it could be entitled to post-petition interest, and reasonable attorney's fees (if provided for in the loan documents), to the extent it is over-secured.³ Conversely, if a creditor is under-secured, then post-petition interest is rarely awarded.

There are several caveats that are worth noting. First, note that a secured creditor gets post-petition interest (and fees) only "to the extent" that it is over-secured. For example, if the value of the collateral is \$10 million and the amount of the debt is \$9,500,000, then the secured creditor is only eligible to receive post-petition interest (and fees) up to a total of \$500,000. Second, a secured creditor's entitlement to *accrue* post-petition interest does not guarantee that it will *receive* payment of that interest. Instead, interest will accrue to the secured creditor's claim. Third, a secured creditor may or may not receive interest at the default rate, even if the loan is in default. Finally, be advised that collateral values often change throughout the course of the case. Accordingly, just because you are over-secured at the beginning of the case does not mean that you will remain over-secured throughout.

E. CAN THE DEBTOR SELL COLLATERAL DURING THE CASE?

The debtor is allowed to sell assets in the ordinary course of its business without court approval. Otherwise, a retail debtor would not be allowed to sell its inventory to retail customers without first seeking court approval. Such a scenario is obviously unworkable. However, if the sale is outside the ordinary course of business, then court approval is required.

³ See 11 U.S.C. §506(b).

As a general rule, the sale of an asset subject to a lien will usually result in the lien remaining with the asset. Thus, if the debtor sells real property that is encumbered by a mortgage, the mortgage will continue to encumber the building, even after sale (unless the proceeds from the sale are used to pay the lien in full). However, most debtors want to sell their assets "free and clear" of all liens, claims, and encumbrances. This can be accomplished pursuant to §363(f) if one of the five criteria set forth therein are satisfied. The most common of these criteria are that the secured creditor consents to the sale, or the sale price is greater than the amount of the debt encumbering the asset to be sold. In such a case, the lien against the asset is transferred to the proceeds from the sale of that asset. The proceeds are often promptly used to pay off the lien.

Finally, when a secured creditor's collateral is sold, the creditor has the right to "credit bid" at the sale pursuant to §363(k) of the Bankruptcy Code. Through this process, the secured creditor is allowed to bid up to the value of its debt, rather than bidding cash. This process offers an extra level of protection against the sale of collateral for less than fair market value or for the amount owed to the secured creditor, whichever is less.

F. WHAT HAPPENS IF THE CHAPTER 11 CASE GETS CONVERTED TO CHAPTER 7?

The primary goal of a Chapter 7 case is to liquidate the debtor's assets and distribute the proceeds to unsecured creditors. This goal, however, is rarely achieved as the overwhelming majority of chapter 7 cases result in no distribution. Here is how it works: if a secured creditor's collateral is worth more than the liens encumbering it (plus the cost of sale), then the Chapter 7 trustee will likely sell the collateral, pay the cost of sale and liens, take his commission, and distribute the remainder to unsecured creditors. However, if the collateral is worth less than the liens encumbering it, then the trustee will likely abandon the collateral or, alternatively, consent to relief from the stay so that the secured creditor can foreclose. The bottom line is that in a Chapter 7 case, a secured creditor is likely to get either (1) repayment of its debt, or (2) title to or possession of its collateral. Most times, a secured creditor's collateral is worth a lot more if it can be liquidated as part of a "going-concern" rather than in straight asset sale, sometimes referred to as a "fire sale." However, "going-concern" sales can usually only be achieved in Chapter 11 cases. In rare cases, the bankruptcy court may authorize a Chapter 7 trustee to continue to operate the business in order to achieve a greater distribution for unsecured creditors.

G. WHAT IS THE IMPACT OF POST-PETITION FINANCING ON A SECURED CREDITOR?

It is not uncommon for a debtor to require new post-petition financing in order to be able to operate during the bankruptcy. As you might imagine, financing for a debtor-in-possession is difficult to come by. However, §364 of the bankruptcy code does provide some inducement to the post-petition lender. This topic is too complex to fully address as part of this program. For now, only the most important issues that are relevant to the pre-petition secured creditor will be addressed.

Post-petition lenders usually require a lien upon assets of the estate before making a debtor-in-possession (DIP) loan. Courts will usually approve this, but only if the debtor can show that post-petition financing on an unsecured basis is unavailable.

If the debtor possesses assets that are unencumbered, the debtor may pledge these assets to the DIP lender as security for the post-petition loan. Typically, such a scenario is not a cause for concern for the pre-petition secured creditor. Unfortunately, there are rarely sufficient unencumbered assets to make a DIP lender comfortable. In these cases, however, the court may still grant the DIP lender a lien against already encumbered assets (i.e. a pre-petition lender's assets). This lien may be subordinate to the existing lien of the pre-petition lender, on an equal priority with the existing lien of the pre-petition lender ("*pari passu*"), or even senior in priority to the existing liens("priming").

As you might expect, the debtor must offer something in exchange for either a *pari passu* lien or a priming lien. As you may have already guessed, that something is adequate protection. Rest assured, though, it is very difficult to get permission from the court to obtain a priming lien over the objection of the pre-petition secured creditor. This is because doing so usually imposes a significant risk of loss upon the pre-petition lender. Therefore, the case law imposes a heavy burden upon the debtor seeking a priming lien over the objection of a pre-petition lender. It can be done, however, particularly in cases where the existing secured lender is substantially over-secured.

In some cases, a pre-petition secured lender will consent to a *pari passu* or priming lien. This typically occurs when the pre-petition secured lender realizes that the debtor must have new financing in order to continue operations, and therefore to preserve the value of its collateral, but the pre-petition secured lender does not want to extend its risk by providing a DIP loan to the debtor. Under these circumstances, it makes sense to agree to subordinate, or share, its pre-petition position in favor of, or with, a new lender. Almost all priming liens are done on a consensual basis.

Sometimes the DIP lender is also the pre-petition secured lender. The pre-petition secured lender is a natural candidate for extending a DIP loan because it is already familiar with the debtor and its operations and has the incentive to protect its pre-petition investment. In such a case, the lender may agree to "prime" its pre-petition loan with the new DIP loan. This is typically much easier to accomplish than in the case where the party extending the DIP loan is a new lender.

H. HOW WILL A SECURED CREDITOR BE TREATED IN THE EVENT A CHAPTER 11 PLAN IS CONFIRMED?

In most cases when a plan is confirmed, the debtor, the secured creditor, and possibly the committee of unsecured creditors reach an agreement of some sort which is reflected in the terms of the confirmed plan. Although the possibilities are almost endless, the deal may involve the sale of collateral, conveyance of some or all of the collateral to the secured creditor, partial pay down, restructuring of the pre-petition loan, third-party lender refinancing, the granting of additional collateral, giving of equity in the business to a creditor, etc.

In cases where no agreement is reached, the debtor may resort to the "cramdown" provisions of the Bankruptcy Code. These code provisions allow the debtor to modify the terms of a secured obligation, even over the objection of the secured creditor, provided the debtor has the support of at least one impaired class of creditors. An impaired class is a class of creditors whose rights are modified in some

way by the plan. There are three options available to a debtor seeking to "cramdown" a secured creditor. These options are set forth in §1129(b)(2)(A).

The first option is to give the secured creditor a note secured by existing collateral in a principal amount equal to the value of the collateral, payable at a market interest rate. The interest-rate will depend on a number of factors, including the length of the term involved. As a basic rule, the longer the term, the higher the risk and therefore the higher the rate. Creditors also have the option to select the "fully-secured" option provided for under §1111(b). This option requires the debtor to provide principal and interest payments over the life of the plan that are equal to the total amount of the secured creditor's debt. This election has disadvantages and is frequently threatened, but rarely invoked. However, if you are representing an under-secured creditor, you should at least consider it.

The second option involves liquidation. In this case the debtor usually sells the creditor's collateral, giving the creditor a lien on the sale proceeds. The debtor then has the option to either pay off the loan using the sale proceeds or, alternatively, give the creditor a note secured by the cash proceeds.

The third option is to provide the secured creditor with the "indubitable equivalent." Generally acknowledged as one of the most cryptic phrases in the Bankruptcy Code, the concept of indubitable equivalence is barely understood. In most cases, this concept is invoked when the debtor wants to reconvey a secured creditor's collateral back to the secured creditor as full satisfaction of the secured debt. In other cases, the debtor may seek to convey to the over-secured creditor only part of the collateral to extinguish the full debt, arguing that the value of the collateral tendered is sufficient to make the creditor whole.

The legislative history probably provides the best guidance on this issue. The general concept of adequate protection as defined by the indubitable equivalence is to require such relief as will result in the realization of value. H. Rept. No. 95-595, p. 340. Also, the Supreme Court has spoken to the timing of the "indubitable equivalent". The realization of the indubitable equivalent as adequate protection in the reorganization context does not have to occur at once, but only upon completion of the reorganization. United Sav. Ass'n of Texas v Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988). These concepts should help to guide you through the difficult concept of indubitable equivalence.

Chapter Ten

Shark Tank

Chapter Ten
Section 1

Third Party Releases

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THIRD-PARTY RELEASES

I. Commonly Released Third Parties

- Debtors' officers, directors, employees
- Debtors' attorneys, financial advisors and other professionals
- Creditors' committee and its professionals
- Debtors' lenders
- Corporate parents
- Insurers and sureties
- Guarantors
- Plan sponsors
- Equity holders
- Liquidating trustees
- Successors and assigns

II. Relevant Code Provisions

- The Bankruptcy Code does not expressly authorize third-party releases, except in connection with asbestos trusts under 11 U.S.C. § 524(g).
- Courts and litigants have cited the following provisions as authority for and against third-party releases:
 - 11 U.S.C. § 105(a) – “The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”
 - 11 U.S.C. § 524(e) – “[d]ischarge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.”
 - 11 U.S.C. § 1123(b) – “Subject to subsection (a) of this section, a plan may ...
 - (3) provide for ... the settlement or adjustment of any claim or interest belonging to the debtor or to the estate ...
 - (6) include any other provision not inconsistent with the applicable provisions of this title.”

III. Relevant Considerations

- Have the creditors consented to the third-party releases?
 - “Affirmative Consent” – third-party releases are binding only on creditors who vote in favor of the Plan or contractually consent.
 - “Artificial Consent” – third-party releases are binding on creditors who are given the opportunity to “opt out” but take no action on the Plan.
- Are the proposed releasees contributing to the Plan?
- Does the Bankruptcy Court have jurisdiction over the claims being released? In other words, would the claims being released affect the estate (for example, by giving rise to indemnification or contribution obligations) or are they claims between third parties arising independent of the bankruptcy?

IV. Split Among the Circuits

A Third-Party Releases Invalid Per Se

Ninth Circuit

- *Resorts Int’l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394 (9th Cir. 1995) (“[W]ithout exception, ... § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors.”).

Tenth Circuit

- *Lansing Diversified Props. II v. First Nat’l Bank & Trust Co. of Tulsa (In re Western Real Estate Fund)*, 922 F.2d 592 (10th Cir. 1990)(nondebtor releases are prohibited except in an asbestos context).

B. Only Consensual Third-Party Releases Permissible

Fifth Circuit

- *In re Pacific Lumber*, 584 F.3d 229, 252 (5th Cir. 2009).
 - Section 524(e) and Fifth Circuit precedent “seems to broadly foreclose nonconsensual, nondebtor releases and permanent injunctions.”
 - Exception: § 1103(c) implies Creditors’ Committee members have qualified immunity for actions within the scope of their duties.

C. Non-Consensual Third-Party Releases Permissible In Certain Circumstances

Second Circuit

- *In re Drexel Burnham Lambert Group Inc.*, 960 F.2d 285, 293 (2d Cir. 1992).
 - Stating with minimal analysis that non-consensual third-party releases permissible if they play “an important part in debtor’s reorganization plan.”
- *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136 (2d Cir. 2005)(ultimately dismissed appeal of releases as equitably moot because plan had been substantially consummated).
 - Clarifies the need for specific factual findings based on evidence presented, dialing back the lenient approach adopted in *Drexel*, while cautioning that analysis should not be “a matter of factors and prongs.”
 - “[A] nondebtor release is not adequately supported by consideration simply because the nondebtor contributed something to the reorganization and the enjoined creditor took something out.”
 - The release must not only be important to the plan, but also “truly unusual circumstances” must exist to render the full scope of the release essential.
- *In re SunEdison Inc.*, 576 B.R. 453, 458 (Bankr. S.D.N.Y. 2017).
 - While “some form of a third-party release may appropriately bind non-voting creditors...,” the proposed releases were impermissibly broad because debtors owed indemnification obligations to only a handful of the released parties.
- *In re Genco Shipping & Trading Ltd.*, 513 B.R. 233, 271 (Bankr. S.D.N.Y. 2014).
 - Approving three subsets of third-party releases:
 - Consensual releases, including not only creditors who voted to accept the Plan, but also creditors who voted to reject but failed to opt out;
 - Releases for claims that would trigger pre-existing indemnification or contribution claims against the debtors, thus impacting debtors’ reorganization, but not newly created indemnification obligations;
 - Releases as to those parties who have provided substantial consideration to the reorganization.

Third Circuit

- *In re Continental Airlines*, 203 F.3d 203 (3d Cir. 2000).
 - Third Circuit declined to adopt bright-line rule on permissibility of third-party releases but found proposed release did “not pass muster under even the most flexible tests for the validity of non-debtor releases.”
 - The mere fact that reorganized debtors might face an indemnity claim for an unspecified amount in the future does not automatically suffice to make the release necessary to ensure the success of the reorganization.
- *In re Lower Bucks Hosp.*, 488 B.R. 303 (E.D. Pa. 2013), *aff'd*, 571 Fed. Appx. 139 (3d Cir. 2014)(hallmarks of permissible non-consensual releases not present due to lack of adequate disclosure).
 - For non-consensual releases to be appropriate, plan proponents must demonstrate:
 - there is a relationship between the debtors’ successful reorganization and the non-consensual parties’ release;
 - the releasees have provided a critical financial contribution to the debtors’ plan that is necessary to make the plan feasible.
- *In re Indianapolis Downs LLC*, 486 B.R. 286, 305-06 (Bankr. D. Del. 2013)(adopting a more “flexible approach” to consent than *Washington Mut.* and concluding that impaired creditors and unimpaired creditors who abstained from voting and did not opt out were bound by third-party releases).
- *In re Washington Mut. Inc.*, 442 B.R. 314, 355 (Bankr. D. Del. 2011).
 - “Failing to return a ballot is not a sufficient manifestation of consent to a third-party release.”
 - “[A]ny third party release is effective only with respect to those who affirmatively consent to it by voting in favor of the Plan and not opting out”

Fourth Circuit

- *Nat’l Heritage Found. v. Highbourne Found.*, 2014 U.S. App. LEXIS 12144 (4th Cir. June 27, 2014).
 - Third party releases should only be approved “cautiously and infrequently.”

- Reviewing the record to assess whether the *Dow Corning* factors had been met; while a debtor need not demonstrate that all factors are met, the proposed third-party releases were inappropriate where only one factor was met.

Sixth Circuit

- *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002) (“[E]njoining a nonconsenting creditor’s claim is only appropriate in ‘unusual circumstances.’”).
- Under 11 U.S.C. § 1123(b)(6), bankruptcy court has substantial equitable power to reorder creditor-debtor relations as needed to achieve a successful reorganization, including to enjoin non-consenting creditors’ claims against non-debtors.
- Non-consenting creditors’ claims against non-debtors may be enjoined where the following factors are present:
 - an identity of interest between the debtor and third party, such as an indemnity relationship, such that a suit against the non-debtor will deplete estate assets;
 - the non-debtor has contributed substantial assets to the reorganization;
 - the injunction is essential to the reorganization;
 - the impacted class or classes have overwhelmingly voted to accept the plan;
 - the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction;
 - the plan provides an opportunity for those claimants who elect not to settle to recover in full;
 - the bankruptcy court makes a record of specific factual findings that support its conclusion.
- Remanding for further proceedings because the bankruptcy court did not make sufficiently particularized findings concerning the above factors.

Seventh Circuit

- *In re Ingersoll, Inc.*, 562 F.3d 856, 864 (7th Cir. 2009)(third-party releases should be approved only if “necessary for the reorganization and appropriately tailored.”).

- *Airadigm Communications, Inc. v. Federal Communications Comm’n (In re Airadigm Communications, Inc.)*, 519 F.3d 640 (7th Cir. 2008).
 - Because § 524(e) does not include the words “shall” or “will,” it does not prevent the court from making a specific ruling altering third-party liability.
 - However, “whether a release is ‘appropriate’ for the reorganization is fact-intensive and depends on the nature of the reorganization.”

Eleventh Circuit

- *In re Seaside Eng’g & Surveying, Inc.*, 780 F.3d 1070 (11th Cir. 2015)(approving third-party releases in favor of debtor’s former principals who would be key employees of the reorganized debtors even though their only contribution was their labor).

Chapter Ten
Section 2

Cannabis Businesses

Submitted By
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[Garvin v. Cook Invs. NW, SPNWY, LLC](#)

United States Court of Appeals for the Ninth Circuit

December 3, 2018, Argued and Submitted, Seattle, Washington; May 2, 2019, Filed

No. 18-35119

Reporter

922 F.3d 1031 *; 2019 U.S. App. LEXIS 13235 **; Bankr. L. Rep. (CCH) P83,392; 67 Bankr. Ct. Dec. 34

GREGORY M. GARVIN, Acting United States Trustee for Region 18, Appellant, v. COOK INVESTMENTS NW, SPNWY, LLC; COOK INVESTMENTS NW, FERN, LLC; COOK INVESTMENTS NW, LLC; COOK INVESTMENTS NW, DARR, LLC; COOK INVESTMENTS NW, ARL, LLC, Appellees.

Prior History: **[**1]** Appeal from the United States District Court for the Western District of Washington. Benjamin H. Settle, District Judge, Presiding. D.C. No. 3:17-cv-05516-BHS.

[Garvin v. Cook Invs. NW, SPNWY, LLC \(In re Cook Invs. NW, SPNWY, LLC\), 2018 U.S. Dist. LEXIS 49640 \(W.D. Wash., Mar. 26, 2018\)](#)

Disposition: AFFIRMED.

Summary:

SUMMARY*

Bankruptcy

The panel affirmed the district court's decision affirming the bankruptcy court's order confirming the second amended Chapter 11 plan of five real estate holding companies.

One of the debtors leased property to a company that used the property to grow marijuana. The United States trustee objected that the lease violated federal drug law, and so the plan was unconfirmable under [11 U.S.C. § 1129\(a\)\(3\)](#) because it was proposed by means forbidden by law.

The panel held that [§ 1129\(a\)\(3\)](#) directs bankruptcy courts to police the means of a reorganization plan's

* This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

proposal, not its substantive provisions. The panel affirmed confirmation of the plan because it was not proposed by any means forbidden by law.

Counsel: Sonia Carson (argued) and Mark B. Stern, Appellate Staff; Annette L. Hayes, Acting United States Attorney; Joseph H. Hunt, Assistant Attorney General; Civil Division, United States Department of Justice, Washington, D.C.; Wendy Cox, Trial Attorney; P. Matthew Sutko, Associate General Counsel; Ramona D. Elliott, Deputy Director/General Counsel; Department **[**2]** of Justice, Executive Office for United States Trustees, Washington, D.C.; for Appellant.

James L. Day (argued) and Aditi Paranjpye, Bush Kornfeld LLP, Seattle, Washington, for Debtors-Appellees.

Judges: Before: Susan P. Graber, M. Margaret McKeown, and Morgan Christen, Circuit Judges. Opinion by Judge McKeown.

Opinion by: M. Margaret McKeown

Opinion

[*1033] McKEOWN, Circuit Judge:

Facing insolvency, five real estate holding companies owned and managed by Michael Cook (collectively, "Cook" or the "Cook companies") sought Chapter 11 protection. Cook's foray into Chapter 11 was by most standards a resounding success. It culminated with the Second Amended Joint Debtors' Plan of Reorganization ("Amended Plan"), which paid all creditors in full and provided for Cook to continue as a going concern. The Amended Plan was confirmed by the bankruptcy court.

But now the United States Trustee ("Trustee") asks that the Amended Plan go up in smoke, because one of the Cook companies leases property to N.T. Pawloski, LLC ("Green Haven"), which uses the property to grow marijuana. The Trustee complains that, even if Green

Haven's business complies with Washington law, the lease itself violates federal drug law. The Trustee reasons that this **[**3]** violation proves the Amended Plan was "proposed . . . by . . . means forbidden by law" and is thus unconfirmable under [11 U.S.C. § 1129\(a\)\(3\)](#).

The problem with the Trustee's theory is that it ignores the plain text of [§ 1129\(a\)\(3\)](#), which directs bankruptcy courts to police the means of a reorganization plan's *proposal*, not its substantive provisions. Resolution of this appeal rests on a straightforward question of statutory interpretation rather than on any conflict between federal and state drug laws. We affirm confirmation of the Amended Plan because it was not proposed "by any means forbidden by law."

BACKGROUND

Cook Investments NW, DARR, LLC ("Cook DARR"), one of the Cook companies, owns commercial real estate in Darrington, Washington (the "Darrington Property"). Cook DARR leased the Darrington Property to two tenants, one of which was Green Haven. The lease with Green Haven (the "Green Haven Lease") provides that Green Haven will use the Darrington Property exclusively as a marijuana establishment. Although Green Haven appears to be in compliance with Washington law, the Green Haven Lease puts Cook in violation of the federal [Controlled Substances Act, 21 U.S.C. §§ 801-971](#), which prohibits "knowingly . . . leas[ing] . . . any place **[**4]** . . . for the purpose of manufacturing, distributing, or using any controlled substance," *id.* [§ 856\(a\)\(1\)](#).

In 2009, one of the Cook companies defaulted on a loan from Columbia State Bank. The loan was secured by Cook's real estate holdings, including the Darrington Property. The bank won default judgments against Cook in state court. Although Cook and the bank reached forbearance agreements, Cook failed to fulfill the agreements' terms. The bank then obtained state-court orders appointing receivers for Cook's properties. At that point, all of the Cook companies filed Chapter 11 bankruptcy petitions, which the bankruptcy court ordered jointly administered.

The Trustee filed a motion to dismiss Cook DARR's Chapter 11 case, asserting that the Green Haven Lease constituted gross mismanagement and thus cause to dismiss under [11 U.S.C. § 1112\(b\)](#). The bankruptcy court denied the motion to dismiss, but with leave to renew at the plan confirmation hearing.

Cook filed the Amended Plan, which provides for repayment of all creditors' claims in full and for Cook to continue as a going concern. The Amended Plan incorporates **[*1034]** by reference an earlier Chapter 11 Plan Agreement between Cook and Columbia State Bank, but in the Amended **[**5]** Plan Cook rejected the Green Haven lease and structured the plan so that his monthly obligations would be paid without revenue from Green Haven. Cook's counsel also explained at argument that, pursuant to the Amended Plan, Cook's other tenants pay their rent directly to Columbia State Bank in satisfaction of its claim, while Green Haven rents were presumably paid directly to Cook.

The bankruptcy court confirmed the Amended Plan, over the Trustee's objection that it violated [§ 1129\(a\)\(3\)](#)'s requirement that a plan be "proposed in good faith and not by any means forbidden by law." The Trustee was the only objector; Cook's creditors fully supported the Amended Plan, which satisfactorily provided for their repayment. Because the Trustee failed to renew its motion to dismiss at the confirmation hearing, the district court affirmed the denial of the motion to dismiss Cook DARR's case. Following confirmation, the Trustee moved for a stay, but the district court denied the request. As a result, Cook has continued to make payments pursuant to the Amended Plan during the pendency of this appeal. The unsecured creditors have been repaid and the secured creditor, Columbia State Bank, is in the process of being **[**6]** repaid.

ANALYSIS

On appeal, the Trustee first challenges the bankruptcy court's refusal to dismiss Cook DARR under [§ 1112\(b\)](#) for "gross mismanagement of the estate." [11 U.S.C. § 1112\(b\)\(4\)\(B\)](#). We need not decide the merits of this issue because, like the district court, we conclude the Trustee waived the argument by failing to renew its motion to dismiss.

The bankruptcy court initially denied the motion to dismiss but explicitly invited the Trustee to renew the motion at the plan confirmation hearing. The Trustee chose, at its peril, not to do so. As the district court put it: "The Trustee failed to renew the motion or subsequently raise the gross mismanagement argument. Although the Debtors fail to raise waiver, it seems to be plain error for this Court to reverse the bankruptcy court's denial when the Trustee failed to renew its motion." This failure was especially significant

because it meant the bankruptcy court had no opportunity to consider whether the claimed gross mismanagement had been "cured." As a consequence, neither the bankruptcy court, nor the district court, nor this court could properly determine the applicability of the exception to dismissal for "unusual circumstances." See [11 U.S.C. § 1112\(b\)\(2\)](#) (exception to dismissal **[**7]** for unusual circumstances applies only if, *inter alia*, cause for dismissal "will be cured within a reasonable period of time"); cf. [Walsh v. Nev. Dep't of Human Res.](#), [471 F.3d 1033, 1037 \(9th Cir. 2006\)](#) (holding that a claim raised in the complaint was waived when it was not re-raised in response to a motion to dismiss, because "the district court had no reason to consider the contention that the claim . . . could not be dismissed" (internal quotation marks omitted)).¹

We therefore turn to the issue of confirmation. To be confirmed, the Amended Plan had to satisfy [§ 1129\(a\)](#), which provides that "[t]he court shall confirm a plan only if" sixteen enumerated requirements are met. The third requirement is that "[t]he plan has been proposed in good faith **[*1035]** and not by any means forbidden by law." [11 U.S.C. § 1129\(a\)\(3\)](#). Only the second prong is at issue here. Because it appears that Cook continues to receive rent payments from Green Haven, which provides at least indirect support for the Amended Plan, the Trustee asserts that it was "proposed . . . by . . . means forbidden by law." [11 U.S.C. § 1129\(a\)\(3\)](#).

We determine de novo the proper interpretation of [§ 1129\(a\)\(3\)](#). See [Tighe v. Celebrity Home Entm't, Inc. \(In re Celebrity Home Entm't, Inc.\)](#), [210 F.3d 995, 997 \(9th Cir. 2000\)](#) (reviewing de novo the bankruptcy court's interpretation of the Bankruptcy Code). Whether the Amended Plan was confirmable depends on whether [§ 1129\(a\)\(3\)](#) forbids **[**8]** confirmation of a plan that is proposed in an unlawful manner as opposed to a plan with substantive provisions that depend on illegality, an issue of first impression in the Ninth Circuit.

Like the First Circuit Bankruptcy Appellate Panel, we conclude that [§ 1129\(a\)\(3\)](#) directs courts to look only to the proposal of a plan, not the terms of the plan. [Irving Tanning Co. v. Me. Superintendent of Ins. \(In re Irving](#)

[Tanning Co.\)](#), [496 B.R. 644, 660 \(B.A.P. 1st Cir. 2013\)](#). This reading accords with both the statutory text, which does not refer to the substance of the plan, and the weight of persuasive authority. See [In re Gen. Dev. Corp.](#), [135 B.R. 1002, 1007 \(Bankr. S.D. Fla. 1991\)](#) ("Courts addressing the issue have uniformly held that [Section 1129\(a\)\(3\)](#) does not require that the contents of a plan comply in all respects with the provisions of all nonbankruptcy laws and regulations." (internal quotation marks omitted)).

It is true that some bankruptcy courts have accepted the Trustee's interpretation. In concluding that a bankruptcy case should be dismissed "[b]ecause a significant portion of the Debtor's income [wa]s derived from an illegal activity," the Bankruptcy Court of Colorado stated that "[§ 1129\(a\)\(3\)](#) forecloses any possibility of this Debtor obtaining confirmation of a plan that relies in any part on income derived from a criminal activity." [In re Rent-Rite Super Kegs W. Ltd.](#), [484 B.R. 799, 809 \(Bankr. D. Colo. 2012\)](#) (footnote omitted). But such decisions fail to "square[] that **[**9]** understanding with [subsection \(a\)\(3\)](#)'s express focus on the manner of the plan's proposal." [Irving Tanning](#), [496 B.R. at 660](#).

Turning to the statute, the phrase "not by any means forbidden by law" modifies the phrase "[t]he plan has been proposed." An interpretation that reads the words "has been proposed" out of the second prong of the requirement would be grammatically nonsensical, i.e., "The plan has been . . . not by any means forbidden by law." Moving the reference to illegality to before "proposed" fares no better, i.e., "The plan, not by any means forbidden by law, has been proposed in good faith." The Trustee's position would require us to rewrite the statute completely, rather than resort to its clear meaning. See [Duncan v. Walker](#), [533 U.S. 167, 174, 121 S. Ct. 2120, 150 L. Ed. 2d 251 \(2001\)](#) ("It is our duty to give effect, if possible, to every clause and word of a statute." (internal quotation marks omitted)).

A contrary interpretation not only renders the words "has been proposed" meaningless, but makes other provisions of [§ 1129\(a\)](#) redundant. For example, [§ 1129\(a\)\(1\)](#) requires that "[t]he plan complies with the applicable provisions of this title." If [§ 1129\(a\)\(3\)](#) is read to mean that the plan must comply with all applicable law, there would be no need for a separate requirement that the plan comply with the provisions of the Bankruptcy **[**10]** Code specifically.²

¹ Although Cook did not raise this issue, the district court ruled on this ground, and the Trustee addressed the issue in its briefing, so Cook's failure to raise waiver did not prejudice the Trustee. See [Hall v. City of Los Angeles](#), [697 F.3d 1059, 1071 \(9th Cir. 2012\)](#) ("We may consider an issue sua sponte . . . if the opposing party will not suffer prejudice.").

² [Section 1129\(a\)\(16\)](#), which requires that "transfers of

[*1036] We do not believe that the interpretation compelled by the text will result in bankruptcy proceedings being used to facilitate legal violations. To begin, absent waiver, as in this case, courts may consider gross mismanagement issues under [§ 1112\(b\)](#). And confirmation of a plan does not insulate debtors from prosecution for criminal activity, even if that activity is part of the plan itself. [In re Food City, Inc., 110 B.R. 808, 812 \(Bankr. W.D. Tex. 1990\)](#). There is thus no need to "convert the bankruptcy judge into an ombudsman without portfolio, gratuitously seeking out possible 'illegalities' in every plan," a result that would be "inimical to the basic function of bankruptcy judges in bankruptcy proceedings."³ *Id.*

Because the Amended Plan was lawfully proposed, the Bankruptcy Court correctly concluded that it met the requirements of [11 U.S.C. § 1129\(a\)](#).

AFFIRMED.

End of Document

property under the plan [comply] with [certain] applicable provisions of nonbankruptcy law," would be similarly redundant under the Trustee's interpretation.

³Cases directing courts to look to the "totality of the circumstances" to determine whether a plan was proposed in good faith do not change the analysis here. Under the good faith prong of [§ 1129\(a\)\(3\)](#), courts must determine whether the plan "achieves a result consistent with the objectives and purposes of the Code." ***Platinum Capital, Inc. v. Sylmar Plaza, L.P. (In re Sylmar Plaza, L.P.)***, 314 F.3d 1070, 1074 (9th Cir. 2002); see also [In re Emmons-Sheepshead Bay Dev. LLC](#), 518 B.R. 212, 225 (Bankr. E.D.N.Y. 2014) ("The good-faith test speaks more to the process of plan development than to the content of the plan." (internal quotation marks omitted)); [In re 431 W. Ponce de Leon, LLC](#), 515 B.R. 660, 673 (Bankr. N.D. Ga. 2014) (holding both that, "[i]n assessing whether the plan was proposed in good faith, the assessment is focused on the plan itself" and "[§ 1129\(a\)\(3\)](#) requires that only the *plan's proposal*, as opposed to the contents of the plan, be in good faith and in compliance with all nonbankruptcy laws" (internal quotation marks omitted)). Here, the Amended Plan provides for the creditors' repayment and the debtors' ongoing operations, so it is consistent with the objectives and purpose of the Bankruptcy Code.

In re Basrah Custom Design, Inc.

United States Bankruptcy Court for the Eastern District of Michigan, Southern Division

May 21, 2019, Decided

Case No. 18-56801, Chapter 11

Reporter

600 B.R. 368 *; 2019 Bankr. LEXIS 1582 **; 67 Bankr. Ct. Dec. 68

In re: BASRAH CUSTOM DESIGN, INC., Debtor.

Subsequent History: Reconsideration denied by [In re Basrah Custom Design, Inc., 2019 Bankr. LEXIS 1860 \(Bankr. E.D. Mich., June 18, 2019\)](#)

Counsel: **[**1]** For Basrah Custom Design, Inc., dba Basrah Store Fixtures And Display, Debtor In Possession: Stuart Sandweiss, Southfield, MI.

For Daniel M. McDermott, U.S. Trustee: Leslie K. Berg (UST), Detroit, MI; Sean M. Cowley (UST), United States Trustee, Detroit, MI.

Judges: Thomas J. Tucker, United States Bankruptcy Judge.

Opinion by: Thomas J. Tucker

Opinion

[*370] OPINION REGARDING THE UNITED STATES TRUSTEE'S MOTION TO DISMISS, THE DEBTOR'S MOTION TO REJECT LEASE, AND THE MOTION BY MJCC 8 MILE, LLC FOR RELIEF FROM STAY

I. Introduction

Among other things, this Chapter 11 case raises the question whether the Debtor's entanglement with a medical marijuana dispensary business, which business is illegal under federal criminal law but not necessarily illegal under Michigan law, requires the dismissal of this federal bankruptcy case. The Court concludes that dismissal is required.

This case came before the Court on March 6, 2019, for a hearing on three motions, namely: (1) the United States Trustee's motion to dismiss this case (Docket # 30, the "Dismissal Motion"); (2) the motion by the Debtor entitled "Debtor's Motion to Reject Executory Lease with

MJCC 8 Mile, LLC" (Docket # 37, the "Lease Rejection Motion"); and (3) the motion by MJCC **[**2]** 8 Mile, LLC for relief from the automatic stay (Docket # 43, the "Stay Relief Motion").

After the hearing, after obtaining leave of Court to do so,¹ the Debtor filed a supplemental brief in further support of its position on the pending motions, and the United States Trustee and MJCC 8 Mile, LLC filed responses to the Debtor's supplemental brief.² The Court has reviewed those post-hearing papers filed by the parties.

The Court has considered all of the oral and written arguments of the parties, and all of the briefs and exhibits filed by the parties. For the reasons stated in this opinion, the Court will deny the Debtor's Lease Rejection Motion, grant the United States Trustee's Dismissal Motion, and deny the Stay Relief Motion as moot.

II. Jurisdiction

This Court has subject matter jurisdiction over this bankruptcy case and this **[*371]** contested matter under [28 U.S.C. §§ 1334\(b\)](#), [157\(a\)](#) and [157\(b\)\(1\)](#), and [Local Rule 83.50\(a\) \(E.D. Mich.\)](#). This is a core proceeding under [28 U.S.C. §§ 157\(b\)\(2\)\(A\)](#), [157\(b\)\(2\)\(G\)](#), and [157\(b\)\(2\)\(O\)](#).

This proceeding also is "core" because it falls within the definition of a proceeding "arising under title 11" and of a proceeding "arising in" a case under title 11, within the meaning of [28 U.S.C. § 1334\(b\)](#). Matters falling within either of these categories in [§ 1334\(b\)](#) are deemed to be core proceedings. **[**3]** See [Allard v. Coenen \(In re Trans-Industries, Inc.\), 419 B.R. 21, 27 \(Bankr. E.D. Mich. 2009\)](#). This is a proceeding "arising under title 11"

¹ See Order Allowing Debtor's Supplemental Brief, [etc.], filed March 18, 2019 (Docket # 90).

² Docket ## 88-1, 96, 99.

because it is "created or determined by a statutory provision of title 11," see *id.*, including [Bankruptcy Code §§ 1112, 365, and 362](#). And this is a proceeding "arising in" a case under title 11, because it is a proceeding that "by [its] very nature, could arise only in bankruptcy cases." See [id. at 27](#).

III. Discussion

A. Background

The Debtor filed this Chapter 11 bankruptcy case on December 16, 2018.³ The Debtor is a Michigan corporation that "is in the business of manufacturing and installing custom cabinets[.]"⁴ The Debtor occupies and uses two conjoined buildings, located at 7451 and 7461 West 8 Mile Road, Detroit, Michigan. That real estate (the "Nocha Property") is owned by Weaam Nocha, who is the President and sole shareholder of the Debtor.⁵ It is undisputed that the Debtor is not, and never has been, an owner of the Nocha Property.⁶

³ This is the Debtor's second Chapter 11 bankruptcy case. The Debtor filed its first such case in this Court on April 19, 2013 (Case No. 13-47956). That case was dismissed on October 25, 2013, with a 180-day bar to refiling, after the Debtor failed to timely file a plan and disclosure statement. See Order Dismissing Case, filed October 25, 2013 (Docket # 79 in Case No. 13-47956).

⁴ Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 2, ¶ 3.

⁵ See Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 2, ¶ 4; Petition (Docket # 1) at 4; Statement Regarding Authority to Sign and File Petition, filed December 16, 2018 (Docket # 3); Statement of Debtor Regarding Corporate Ownership, and List of Equity Security Holders, filed December 25, 2018 (Docket # 10). The Debtor admitted that Weaam Nocha is the owner of the Nocha Property, in answering the United States Trustee's motion to dismiss. (Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 2, ¶ 4.) But in another pleading, involving a different motion, the Debtor stated that the Nocha Property is owned by "Weaam Nocha . . . and his wife, Rafah Dawood[.]" (Debtor's

B. The November 16, 2016 Lease, and the Debtor's pre-petition state court litigation with MJCC 8 Mile, LLC

Before filing this bankruptcy case, the Debtor, Weaam Nocha, and others were defendants in a state court lawsuit filed by MJCC 8 Mile, LLC, captioned *MJCC 8 Mile, LLC v. Basrah Custom Design, Inc., et al.*, Case No. 17-001663 [****4**] (Wayne County, [***372**] Michigan Circuit Court) (the "State Court Lawsuit").

In the State Court Lawsuit, MJCC 8 Mile, LLC ("MJCC") claimed to have the right to possession of the Nocha Property under a written lease, which lease also gave MJCC an option to purchase the Nocha Property. MJCC sought enforcement of that lease and the purchase option. The lease was executed on November 16, 2016, and is referred to in this Opinion as the "November Lease" or the "November 2016 Lease." A copy of the November Lease appears in the record of this case as Exhibit 1 to the brief filed by the Debtor on February 8, 2019.⁷

The November Lease named the Debtor as the "Landlord" and MJCC as the "Tenant," and it was signed on November 16, 2016 by Weaam Nocha for the Debtor, as "Its Owner," and by MJCC.

Under the November Lease, MJCC leased the part of the Nocha Property located at 7461 West 8 Mile Road, for an initial term of 5 years, renewable by MJCC for 6 additional 5-year terms.⁸ During that lease term, MJCC also had the option to lease the adjacent part of the Nocha Property, located at 7451 West 8 Mile Road, also for an initial term of 5 years, renewable by MJCC for 3

Mot. to Enforce the Automatic Stay, [etc.] (Docket # 104) at 1-2, ¶ 2; Debtor's Br. (Docket # 104-1) at 2-3). But in that same pleading, the Debtor stated that this property is owned by "Nocha and/or Dawood." (See Debtor's Mot. to Enforce the Automatic Stay, [etc.] (Docket # 104) at 2, ¶ 5; Debtor's Br. (Docket # 104-1) at 3, 18). In yet another pleading, the Debtor stated that the Nocha Property is owned "by Weaam Nocha and/or his wife, Rafah Dawood." (Debtor's Obj. to MJCC's Mot. to Lift Stay (Docket # 73) at 3). This inconsistency in the Debtor's pleadings is not material to the Court's decision on the pending motions.

⁶ See, e.g., Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 4, ¶ 21.

⁷ Docket # 41-1.

⁸ See November Lease at 1, ¶ 1 and Ex. A thereto.

additional 5-year terms.⁹ The November Lease **[**5]** also gave MJCC an option to purchase the Nocha Property, for \$1.2 million.¹⁰

It is undisputed, and was clearly understood by all parties at the time of the signing of the November Lease, that MJCC's purpose in entering into the November Lease was to use the Nocha Property to operate a medical marijuana dispensary. And this is clear from the face of the November Lease. For example, the document stated that "[t]he Premises will be used for a licensed medical marijuana dispensary (the '**Designated Use**') and for no other purpose whatsoever."¹¹ And the initial 5-year term of the Lease was to begin "on the date Tenant receives approval from the City of Detroit for its Designated Use[.]"¹²

The defendants in the State Court Lawsuit were the Debtor, Weaam Nocha, Rafaa Nocha (Weaam Nocha's wife, a/k/a Rafaa Dawood), Holden Dawood (the Nochas's son), and DMCC, LLC (a limited liability company formed by the defendants). All of the defendants jointly defended against MJCC's claims, and opposed the efforts of MJCC to obtain possession of or purchase the Nocha Property. One of their primary defenses was that MJCC "fraudulently tricked" Weaam Nocha into signing the November Lease.¹³

It is undisputed that in seeking relief in the State Court Lawsuit, and in now seeking stay relief in this Court, MJCC has sought possession and ownership of the Nocha Property, in order to use that property as a medical marijuana dispensary. Such a marijuana business apparently would not violate Michigan law, but as **[*373]** discussed below, it would violate federal criminal law.

C. The State Court Decision

⁹ See *id.* at 12, ¶ 39 and Ex. B thereto.

¹⁰ See *id.* at 12, ¶ 40 and Ex. C thereto; see also discussion of the relief granted by a decision of the state court in the State Court Lawsuit discussed below.

¹¹ November Lease at 2, ¶ 4 (emphasis in original).

¹² *Id.* at 1, ¶ 1.

¹³ The Debtor continues to make this assertion in this bankruptcy case. (See, e.g. **[**6]**, Debtor's Obj. to the U.S. Trustee's Mot. to Dismiss (Docket # 40) at 2, ¶ 8).

The State Court Lawsuit went to trial, and on December 7, 2018, the state court found for MJCC, in a lengthy written opinion and order, entitled "Finding of Facts and Conclusions of Law" (the "State Court Decision"). A copy of the State Court Decision appears in the record of this case as Exhibit 4 to the Debtor's brief filed on February 8, 2019.¹⁴

As discussed in Part III.D of this Opinion, below, the findings and conclusions of the State Court Decision are binding in this Court, on the Debtor, Weaam Nocha, and MJCC, under the doctrine of collateral estoppel. For this reason, and because they are important to this Court's decision on the pending motions, the Court will describe the state court's findings and conclusions in detail.

In the State Court Decision, the state court found and concluded, **[**7]** among other things, that:

- Weaam Nocha was **not** tricked or fraudulently induced into signing the November Lease;¹⁵
- at the time the November Lease was signed, the Nocha Property was owned solely by Weaam Nocha;¹⁶
- Weaam Nocha signed the November Lease as an agent of the Debtor, **and** the Debtor in turn signed the November Lease as agent of and on behalf of the owner of the property at issue, Weaam Nocha;¹⁷
- the November Lease, including the purchase option it contains, is valid and enforceable by MJCC;¹⁸

¹⁴ Docket # 41-4.

¹⁵ See, e.g., State Court Decision at ¶¶ 69, 96, 97.

¹⁶ *Id.* at ¶¶ 155, 156, 168.

¹⁷ See *id.* at ¶¶ 63, 124, 155, 156, 158, 165-170, 176. This latter finding of the state court, that the Debtor signed the November Lease as agent of and on behalf of the sole owner, Weaam Nocha, makes sense because the state court found that Weaam Nocha, not the Debtor, was the "sole owner" of the Nocha Property. Moreover, Weaam Nocha's status as the real party-in-interest lessor under the November Lease is clearly implied in the state court's findings that (1) "as the sole owner of the [Nocha] Property, Mr. Nocha had full authority to grant possessory rights to the [Nocha] Property;" *id.* at ¶ 158; and (2) the Debtor had the authority, as agent, to bind Weaam Nocha to "lease the [Nocha] Property;" see *id.* at ¶¶ 165-167, 170.

¹⁸ See *id.* at ¶¶ 94, 106, 123.

- the term of the November Lease began on November 10, 2016, and MJCC's right to exclusive possession of the Nocha Property began on November 26, 2016.¹⁹

[*374] The State Court Decision found that the Nocha Property is one of the very few properties located within the City of Detroit that is available and suitable for conducting a medical marijuana dispensary. The state court found that "there are very few fully compliant properties in the City [of Detroit]" where one can "open a medical marijuana dispensary."²⁰ This is "due to the tight restrictions imposed by Detroit's Medical Marijuana Zoning Ordinance."²¹ But the Nocha Property is such an available **[**8]** property — as the state court put it, the property is "in the 'green zone.'"²²

The state court also found that the efforts by Weaam Nocha, the Debtor, and the other defendants to avoid enforcement of the November Lease, including its purchase option, were motivated by a desire to make more money from the Nocha Property, either by (1)

renting or selling the Nocha Property to MJCC, or someone else in the medical marijuana business, for a higher rent or a higher sale price than the \$1.2 million price set by the purchase option in the November Lease; or (2) using the property to open and operate a marijuana dispensary themselves.

The State Court Decision described, in detailed findings:²³

- how Weaam Nocha and his wife, Rafaa, continually demanded more money from MJCC for the lease or purchase of the Nocha Property, even after the November Lease was signed, demanding, for example, an increase in rent from the \$5,000.00 per month in the November Lease²⁴ to \$7,500.00 per month, and demanding \$1.5 million to sell the property to MJCC instead of the \$1.2 million agreed to in the November Lease's purchase option;²⁵
- how MJCC refused the Nochas's greater financial demands, and instead insisted on **[**9]** performance of the November Lease;²⁶
- how the Nochas then reacted by refusing to honor the November Lease;²⁷ and

- how all of the state court defendants — *i.e.*, the Debtor, Weaam Nocha, Rafaa Nocha, and their son Holden Dawood — then decided to open and operate a medical marijuana dispensary themselves at the Nocha **[*375]** Property, and

¹⁹ See *id.* at ¶¶ 53, 58, 109, 152. The November Lease was signed on November 16, 2016, and states in the first paragraph that its "Effective Date" was November 16, 2016. (November Lease at 1). As the State Court Decision found, MJCC's right to exclusive possession of the Nocha Property began 10 days after the Effective Date of the November Lease, *i.e.*, on November 26, 2016. (See State Court Decision at ¶ 109; November Lease at 3, ¶ 8).

The "term" of the November Lease, and MJCC's obligation to pay rent, was defined to occur "beginning on the date [MJCC] receives approval from the City of Detroit for its Designated Use [*i.e.*, as a "licensed medical marijuana dispensary"]." (See November Lease at 1, ¶ 1; 2, ¶ 4). As the State Court Decision found, this identical language was contained in an earlier lease signed by the parties on February 15, 2016 (referred to in the State Court Decision as the "February Lease"), which February Lease was later replaced by the November Lease. And the State Court Decision also found that this required approval from the City of Detroit was obtained by MJCC on November 10, 2016. (See State Court Decision at ¶¶ 15, 53, 58, 152). Although the State Court Decision found in one paragraph of the decision that the City of Detroit's approval was a "conditional" approval, (State Court Decision at ¶ 58 ("On November 10, 2016, the City of Detroit granted MJCC conditional approval for a license to operate a [medical marijuana] Dispensary.")), the State Court Decision made clear in at least two other paragraphs that the November 10, 2016 approval by the City of Detroit was sufficient to trigger the beginning of the Lease "term" under the identical language in the February Lease and the November Lease. (See State

Court Decision at ¶ 53 (finding that MJCC's obligation to pay rent under the terms of the February Lease began when it "obtained approval from the City of Detroit to operate a medical marijuana dispensary at the Property . . . [which it obtained on] November 10, 2016"), ¶ 152 (finding that "the date [MJCC] receive[d] approval from the City of Detroit for its Designated Use [a licensed medical marijuana dispensary]" was November 10, 2016 ("MJCC obtained approval from the City of Detroit on November 10, 2016, but Defendants refused to give them possession."))

²⁰ State Court Decision at ¶¶ 2-3.

²¹ *Id.* at ¶ 2.

²² *Id.* at ¶ 5.

²³ See, *e.g.*, *id.* at ¶¶ 54-56, 55 n.5, 59, 70-79, 139-147.

²⁴ November Lease at 1, ¶ 2(a).

²⁵ See, *e.g.*, State Court Decision at ¶¶ 70-74, 55 & n.5.

²⁶ See, *e.g.*, *id.* at ¶¶ 72, 76.

²⁷ See, *e.g.*, *id.* at ¶ 76.

went to great lengths to try to do so; including the defendants' formation of a new LLC — the defendant DMCC, LLC — to obtain a license from the City of Detroit to operate a medical marijuana dispensary.²⁸

Based on its detailed findings, the state court entered a judgment in favor of MJCC and against the defendants.²⁹ For relief, "given the validity of the November 2016 Lease," the State Court Decision ordered that MJCC could elect one of two options.³⁰

Under the first option, MJCC could elect to have a "[d]eclaratory judgment that the November 2016 Lease is valid and enforceable." Under this option, MJCC was required to "exercise[] its option [under the November 2016 Lease] to purchase the entire property (7451 and 7461) for [\$]1.2 million" and MJCC would obtain the "immediate transfer of ownership to [**10] DMCC to Plaintiff[] along with possession of the Property."³¹

Under the second option, MJCC could elect to have a declaratory judgment that "the November 2016 [L]ease [is] null and void," plus a money judgment in the total amount of \$713,658.72.³² Under this option, "Defendants would maintain ownership of the property and the Marijuana license."³³

MJCC elected the first of these alternative forms of relief, and desires to close, as soon as possible, on its purchase of the Nocha Property for the \$1.2 million price. This is so MJCC can begin to operate its medical marijuana dispensary business on the Nocha Property as soon as possible.

Nine days after the State Court Decision, and in direct response to it, the Debtor filed this bankruptcy case. The Debtor and the other state court defendants also filed an appeal of the State Court Decision to the Michigan Court of Appeals, which appeal is pending.

²⁸ See, e.g., *id.* at ¶¶ 76-79, 139-147.

²⁹ *Id.* at 27.

³⁰ *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.*

D. The preclusive effect of the State Court Decision, under the doctrine of collateral estoppel

As the Debtor's counsel conceded during the hearing, the findings and conclusions of the state court in the State Court Decision are binding on the Debtor and MJCC. Those parties are precluded from [**11] contesting such findings and conclusions in this bankruptcy case, under the doctrine of collateral estoppel. And this is so even though the Debtor has appealed the State Court Decision.

This Court previously has explained how collateral estoppel applies in bankruptcy cases, under the federal Full Faith and Credit Statute, [28 U.S.C. § 1738](#).³⁴

"In determining whether a state court judgment precludes relitigation of issues under the doctrine of collateral estoppel, the Full Faith and Credit Statute, [28 U.S.C. § 1738](#), requires bankruptcy courts to "consider first the law of the [**376] State in which the judgment was rendered to determine its preclusive effect." [Bay Area Factors v. Calvert \(In re Calvert\)](#), [105 F.3d 315, 317 \(6th Cir. 1997\)](#)(quoting [Marrese v. Am. Acad. of Orthopaedic Surgeons](#), [470 U.S. 373, 375, 105 S. Ct. 1327, 84 L. Ed. 2d 274 \(1985\)](#)). If the state courts would not deem the judgment binding under collateral estoppel principles, then the bankruptcy court cannot do so either. But if the state courts would give preclusive effect to the judgment, then the bankruptcy court [generally] must also give the judgment preclusive effect[.]"

[Taleb v. Kramer \(In re Kramer\)](#), [543 B.R. 551, 553 \(Bankr. E.D. Mich. 2015\)](#) (footnote omitted) (quoting [McCallum v. Pixley \(In re Pixley\)](#), [456 B.R. 770, 775-76 \(Bankr. E.D. Mich. 2011\)](#)); see also [In re Indiana Hotel Equities, LLC](#), [586 B.R. 870, 875 \(Bankr. E.D. Mich. 2018\)](#) (same).

Because the State Court Decision was entered in the Wayne County Circuit Court in the state of Michigan, the

³⁴ The Full Faith and Credit Statute states, in relevant part:

The . . . judicial proceedings of any court of any . . . State . . . shall have the same full faith and credit in every court within the United States . . . as they have by law or usage in the courts of such State . . . [**12] . . . from which they are taken.

[28 U.S.C. § 1738](#).

Court must look to Michigan law to determine the collateral estoppel effect of that decision. As this Court has explained in prior cases,

Under Michigan law, the following requirements must be met in order for collateral estoppel to apply:

- 1) there is identity of parties across the proceedings,
- 2) there was a valid, final judgment in the first proceeding,
- 3) the same issue was actually litigated and necessarily determined in the first proceeding, and
- 4) the party against whom the doctrine is asserted had a full and fair opportunity to litigate the issue in the earlier proceeding.

Phillips v. Weissert (In re Phillips), 434 B.R. 475, 485 (6th Cir. BAP 2010) (citation omitted).

• . . .

Under Michigan law, an issue is "actually litigated" if it is "put into issue by the pleadings, submitted to the trier of fact for determination, and is thereafter determined." *Phillips*, 434 B.R. at 486 (majority opinion) (quoting *Latimer v. William Mueller & Son, Inc.*, 149 Mich.App. 620, 386 N.W.2d 618, 627 (1986)); *Phillips*, 434 B.R. at 490 (Rhodes, J., concurring) (same).

• . . .

An issue that is "actually litigated" is also considered to be "necessarily determined" if "it is necessary to the judgment." See *id.* at 493; see also *Rohe Scientific Corp. v. Nat'l Bank of Detroit*, 133 Mich.App. 462, 350 N.W.2d 280, 282 (1984) (citation omitted) *Pixley I*, 456 B.R. at 776, 778-79.

Lenchner v. Korn (In re Korn), 567 B.R. 280, 298-99 (Bankr. E.D. Mich. 2017).

With respect to each of the findings and **[**13]** conclusions recounted in this Opinion from the State Court Decision, all of the requirements for the application of collateral estoppel are met: (1) the relevant parties (the Debtor, Weaam Nocha, and MJCC) are the same; (2) the State Court Decision is a valid, final judgment; (3) the issues were actually litigated and necessarily determined by the State Court Decision; and (4) all the parties in the State Court Lawsuit, including the Debtor, Weaam Nocha, and MJCC, had a full and fair opportunity to litigate the issues decided in the State

Court Decision.

The State Court Decision is considered a valid, final judgment for collateral estoppel purposes, even though the Debtor and Weaam Nocha have appealed that decision to the Michigan Court of Appeals. See *Taleb v. Kramer*, 543 B.R. at 559 ("[U]nder Michigan law, a final . . . judgment has preclusive effect under the doctrine of collateral estoppel . . . even when the judgment is on appeal or the time for appeals **[*377]** has not yet expired."). Collateral estoppel therefore applies, and in effect, the parties to the State Court Decision, including the Debtor, Weaam Nocha, and MJCC, are bound by the findings and conclusions in the State Court Decision, unless and until that State **[**14]** Court Decision is reversed, vacated, or modified on appeal. And counsel for the Debtor explicitly conceded this, during the hearing.

E. Discussion of the Debtor's motion to reject the November 2016 Lease, under *Bankruptcy Code* § 365.

In its Lease Rejection Motion, the Debtor seeks an order allowing it to reject the November 2016 Lease. MJCC opposes that motion on several grounds. The United States Trustee also opposes that motion, because he seeks dismissal of this case.

The Court must deny the Debtor's Lease Rejection Motion, for two reasons. First, the November Lease is not a lease that the Debtor may reject under *11 U.S.C. § 365*, because the Debtor is not a real party in interest under that lease. Rather, the Debtor signed the November Lease only in its capacity as agent for the one and only owner of the Nocha Property at issue, namely, Weaam Nocha. This is conclusively established by the State Court Decision, as noted in parts III.C and III.D of this Opinion. As a result, the Debtor cannot assume or reject the November Lease under *§ 365*. That section says that a "trustee," which includes a Chapter 11 debtor-in-possession under *11 U.S.C. § 1107(a)*, "subject to the court's approval, may assume or reject any executory contract or unexpired lease **[**15] of the debtor.**" *11 U.S.C. § 365(a)* (emphasis added). Many of the subsections in *§ 365* use this phrase, executory contract or unexpired lease "of the debtor," and thereby reinforce the point that *§ 365* applies only to such contracts "of the debtor." See, e.g., *11 U.S.C. §§ 365(b)(1), 365(b)(4), 365(c), 365(d)(1), 365(d)(2), 365(e)(1), 365(e)(2), 365(f)(1), 365(f)(2), 365(f)(3), 365(g), 365(i)(1)*.

The November Lease is not a lease "of the debtor" but rather is a lease of the Debtor's 100% shareholder, Weaam Nocha, who at the time of the November Lease was the only owner of the subject property. (As noted in Part III.A of this Opinion, it is undisputed that the Debtor is not and never has been an owner of the subject property.) The Debtor therefore cannot assume or reject the November Lease, so the Debtor's Lease Rejection Motion must be denied.

That Motion also must be denied for a second reason, namely, because this bankruptcy case must be dismissed, for the reasons discussed below.

F. Discussion of the United States Trustee's Dismissal Motion

The United States Trustee (the "UST") seeks dismissal of this bankruptcy case, for "cause" under [11 U.S.C. § 1112\(b\)\(1\)](#). That section states:

(b)(1) Except as provided in [paragraph \(2\)](#) and [subsection \(c\)](#), on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under **[**16]** chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause unless the court determines that the appointment under [section 1104\(a\)](#) of a trustee or an examiner is in the best interests of creditors and the estate.

[11 U.S.C. § 1112\(b\)\(1\)](#). In partially defining what the general "cause" standard in [§ 1112\(b\)\(1\)](#) means, "[\[s\]ection 1112\(b\)\(4\)](#) contains a nonexhaustive list of examples of 'cause' justifying dismissal of a Chapter **[*378]** 11 case." [In re Creekside Sr. Apartments, L.P.](#), [489 B.R. 51, 60 \(B.A.P. 6th Cir. 2013\)](#).

In determining whether cause exists to dismiss a case under [§ 1112\(b\)](#), a court must engage in a "case-specific" factual inquiry which "focus[es] on the circumstances of each debtor." [United Savs. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd. \(In re Timbers of Inwood Forest Assocs., Ltd.\)](#), [808 F.2d 363, 371-72 \(5th Cir.1987\)](#) (en banc), [aff'd](#), [484 U.S. 365, 108 S.Ct. 626, 98 L.Ed.2d 740 \(1988\)](#); [In re Great Am. Pyramid Joint Venture](#), [144 B.R. 780, 791 \(Bankr.W.D.Tenn.1992\)](#).

Id.; see also [In re Skymark Properties II, LLC](#), [597 B.R. 391, 395-96 \(Bankr. E.D. Mich. 2019\)](#).

1. The federal Controlled Substances Act

The UST seeks dismissal of this case because of the Debtor's entanglement with a medical marijuana dispensary business. That business may well be legal under Michigan law,³⁵ and the Court will assume as much for purposes of deciding the Dismissal Motion. But it is clear that such a marijuana dispensary business is illegal under federal law.

There is no dispute that operating a medical marijuana dispensary is a violation of the federal Controlled Substances Act, [21 U.S.C. §§ 801-904](#) (the "CSA"). Marijuana is an illegal **[**17]** Schedule I controlled substance under the CSA, see [21 U.S.C. § 812\(c\)\(10\)](#), despite the adoption by several states in recent years of laws permitting the sale and use of marijuana for medical and/or recreational purposes. See generally [Gonzales v. Raich](#), [545 U.S. 1, 10-15, 125 S. Ct. 2195, 162 L. Ed. 2d 1 \(2005\)](#). As the Supreme Court explained

³⁵ Effective December 4, 2008, Michigan enacted legislation to allow the medical use of marijuana under state law, in the act known as the "Michigan Medical Marihuana Act," [Mich. Comp. Laws Ann. §§ 333.26421 through 333.26430](#). This Act was passed by voter initiative, by the approval of Michigan voters in the November 2008 election. This Act was later amended, with amendments that became effective April 1, 2013, December 20, 2016, and April 10, 2017. Also added to Michigan law, in 2016, was the "Marihuana Tracking Act" (effective December 20, 2016 and later amended effective March 21, 2019), [Mich. Comp. Laws Ann. §§ 333.27901 through 333.27904](#), and the "Medical Marihuana Facilities Licensing Act" (effective December 20, 2016 and later amended effective January 26, 2018, January 1, 2019, March 28, 2019, and April 16, 2019), [Mich. Comp. Laws Ann. §§ 333.27101 through 333.27801](#).

Recently, Michigan enacted legislation to make marijuana legal under state and local law for recreational use, for adults 21 years of age or older. This legislation was passed by voter initiative, by the approval of Michigan voters in the November 2018 election. It became effective on December 6, 2018, and is known as the "Michigan Regulation and Taxation of Marihuana Act," [Mich. Comp. Laws Ann. §§ 333.27951 through 333.27967](#). Among other things, this Act provides for the licensing, regulation, and taxation of "marihuana establishments." The Act gives the Michigan Department of Licensing and Regulatory Affairs up to one year after the effective date of the Act (*i.e.*, until December 6, 2019) to promulgate rules for implementation of the Act. See [Mich. Comp. Laws Ann. §§ 333.27953\(b\), 333.27953\(h\), 333.27957, 333.27958, 333.27966](#).

in *Gonzales v. Raich*,

In enacting the CSA, Congress classified marijuana as a Schedule I drug. [21 U.S.C. § 812\(c\)](#). . . . By classifying marijuana as a Schedule I drug, as opposed to listing it on a lesser schedule, the manufacture, distribution, or possession of marijuana became a criminal offense, with the sole exception being use of the drug as part of a Food and Drug Administration preapproved research study. [§§ 823\(f\), 841\(a\)\(1\), 844\(a\)](#); see also *United States v. Oakland Cannabis [*379] Buyers' Cooperative*, 532 U.S. 483, 490, 121 S.Ct. 1711, 149 L.Ed.2d 722 (2001).

• . . .

Despite considerable efforts to reschedule marijuana, it remains a Schedule I drug.

[545 U.S. at 14-15](#) (footnote omitted). Of the statutes cited by the Supreme Court in *Gonzales v. Raich*, [21 U.S.C. § 841\(a\)\(1\)](#) makes it a crime "knowingly or intentionally . . . to manufacture, distribute, or dispense" a controlled substance, including marijuana, and that statute provides for criminal penalties including imprisonment and fines. *E.g.*, [21 U.S.C. § 841\(b\)\(1\)\(D\)](#).

And as the UST points out, operating a medical marijuana dispensary, or owning or renting a place operating as such a dispensary, also would **[**18]** be a federal crime under [21 U.S.C. § 856\(a\)](#). That section states:

Except as authorized by this subchapter, it shall be unlawful to—

(1) **knowingly open, lease, rent, use, or maintain any place**, whether permanently or temporarily, **for the purpose of manufacturing, distributing, or using any** controlled substance;

(2) **manage or control any place**, whether permanently or temporarily, **either as an owner, lessee, agent, employee, occupant, or mortgagee, and knowingly and intentionally rent, lease, profit from, or make available for use**, with or without compensation, **the place for the purpose of unlawfully** manufacturing, storing, **distributing**, or using a **controlled substance**.

[21 U.S.C. § 856\(a\)\(1\)-\(2\)](#) (emphasis added). Violation of this statute subjects one to possible imprisonment of up to 20 years, and a possible criminal fine of up to \$2 million "for a person other than an individual," as well as

the possibility of substantial civil penalties. See [21 U.S.C. §§ 856\(b\), 856\(d\)](#).

2. Bankruptcy cases

Because of these federal statutes, several bankruptcy courts have found cause to dismiss a bankruptcy case filed by a debtor whose income was derived, directly or indirectly, at least in part, from the business of selling marijuana. For example, in *In re Rent-Rite Super Kegs West Ltd.*, 484 B.R. 799, 802-04 (Bankr. D. Colo. 2012), the bankruptcy court **[**19]** found that the Chapter 11 debtor had "unclean hands," and that "cause" existed under [11 U.S.C. § 1112\(b\)](#) to dismiss or convert the bankruptcy case, because the debtor derived roughly 25% of its revenues from leasing warehouse space to tenants engaged in the business of growing marijuana. The court found that the debtor's business "involves a continuing violation of the federal Controlled Substances Act," even though the marijuana growing activity was "arguably legal under Colorado law." [484 B.R. at 802](#) (footnote omitted). The court held that "a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime." *Id. at 805* (footnote omitted).

This is so, the *Rent-Rite* court held, "even if the Debtor is never charged or prosecuted under the CSA," and even though, generally, "federal prosecutors may well choose to exercise their prosecutorial discretion and decline to seek indictments under the CSA where the activity that is illegal on the federal level is legal under . . . state law." [484 B.R. at 805](#).

In another case arising in Colorado, *Arenas v. United States Trustee (In re Arenas)*, 535 B.R. 845 (B.A.P. 10th Cir. 2015), the Bankruptcy Appellate Panel (the "B.A.P.") for the Tenth Circuit affirmed **[*380]** the bankruptcy court's dismissal of a Chapter **[**20]** 7 case filed by a marijuana grower and his wife. The B.A.P. stated:

Possessing, growing, and dispensing marijuana and assisting others to do that are federal offenses. But like several other states, Colorado has legalized these acts and heavily regulates them, triggering a flourishing marijuana industry there. **Can a debtor in the marijuana business obtain relief in the federal bankruptcy court? No.**

[535 B.R. at 847](#) (emphasis added).

In *Arenas*, one of the joint debtors was licensed in Colorado "to grow and dispense medical marijuana," and he did so in one of the two units of a commercial building that the debtors jointly owned.³⁶ The debtors leased the other unit of their building to an LLC that operated a marijuana dispensary. *Id.* The bankruptcy court denied a motion by the debtors to convert their case to Chapter 13, and granted a motion by the United States Trustee to dismiss the case, for cause under [11 U.S.C. § 707\(a\)](#). *Id.* at 848. The B.A.P. affirmed the bankruptcy court's decisions. The B.A.P. found that while the debtors' activities were legal under Colorado state law, they violated the CSA. *Id.* at 847. It held that "while the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because **[**21]** their marijuana business activities are federal crimes." *Id.* at 849-50. The B.A.P. also held that a bankruptcy trustee could not administer the marijuana assets, including the marijuana plants and the debtors' building, because that would violate federal criminal law. See *id.* at 852-53. The court noted that "[t]he CSA criminalizes virtually every aspect of selling, manufacturing, distributing and profiting from the use of controlled substances." *Id.* at 852 n.40 (citing [21 U.S.C. §§ 841\(a\)\(1\)](#) and [856\(a\)](#)).

Finally, in the case of *In re Way to Grow, Inc.*, [597 B.R. 111 \(Bankr. D. Colo. 2018\)](#), the bankruptcy court dismissed the Chapter 11 cases of three affiliated companies, because of the debtors' involvement in a marijuana-related business. That involvement was more indirect than that of the debtors in the other cases, discussed above. In *Way to Grow*, the court described the debtors' business as follows:

Debtors' business involves the sale of equipment for indoor hydroponic and gardening-related supplies. As to their customers' uses of their products, Debtors have represented "[w]hile the hydroponic gardening equipment may [be] and is used for many types of crops, the Debtors' future business expansion plan is tied to the growing cannabis industry which is heavily reliant on hydroponic gardening."

[597 B.R. at 114-15](#) (footnote omitted). **[**22]** After citing certain provisions of the CSA, namely [21 U.S.C. §§ 812](#) and [841\(a\)\(1\)](#), quoted above, the court in *Way to Grow* further noted that

the CSA prohibits any person from possessing or distributing "any equipment . . . product or material

which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance" in violation of federal law. The CSA also expressly provides any person who "conspires to commit any offense" under the CSA shall be subject to the same penalties as the principal.

[597 B.R. at 116](#) (footnotes omitted) (citing [21 U.S.C. §§ 843\(a\)\(6\)](#), [843\(a\)\(7\)](#), and [846](#)).

The *Way to Grow* court observed that "bankruptcy courts have consistently dismissed cases where debtors engaged in **[*381]** ongoing CSA violations, or where a debtor's reorganization efforts depend on funds which can be considered proceeds of CSA violations." [597 B.R. at 117](#).³⁷ The court ultimately concluded that the debtors' business violated the CSA, both before and after filing their bankruptcy cases:

Debtors certainly know they are selling products to customers who will, and do, use those products to manufacture a controlled substance in violation of the CSA. Debtors tailor their business to cater to **[**23]** those needs, tout their expertise in doing so, and market themselves consistent with their knowledge. There is no evidence this business model has materially changed post-petition.

The Court concludes Debtors' business model and execution thereof fundamentally violates [§ 843\(a\)\(7\)](#). These violations continue post-petition, .

...

Id. at 131. Because of this, the court found, "inescapably," that there was cause to dismiss the bankruptcy case under [11 U.S.C. § 1112\(b\)](#). *Id.* at 132.

³⁷ The *Way to Grow* court noted that "there remains an ever-shifting landscape of federal enforcement of marijuana criminalization where the same activity is fully legal under state law." [597 B.R. at 117](#) (footnote omitted). As an example of this "ever-shifting landscape," the court cited the Trump administration's 2018 revocation of the enforcement policy announced in 2013 by the Obama administration. *Id.* at 117 n.24 (citing "James M. Cole, Deputy Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: GUIDANCE REGARDING MARIJUANA ENFORCEMENT (Aug. 29, 2013) (commonly known as the "Cole Memo"); but see Jeffrey B. Sessions, Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: MARIJUANA ENFORCEMENT (January 4, 2018) (revoking Cole Memo)").

³⁶ *Id.*

And because the court saw "no practical alternative to dismissal," the court dismissed the bankruptcy case. *Id.* This result, the court held, was necessary "[t]o prevent this Court from violating its oath to uphold federal law[.]" *Id.*³⁸

³⁸In addition to the cases discussed in this Opinion, this Court has reviewed and considered all of the cases cited by the parties. And the Court is aware of the May 2, 2019 decision by the Ninth Circuit Court of Appeals, in [Garvin v. Cook Invs. NW, No. 18-35119, 922 F.3d 1031, 2019 U.S. App. LEXIS 13235, 2019 WL 1945280 \(9th Cir. May 2, 2019\)](#). In *Garvin*, the Court of Appeals for the Ninth Circuit affirmed a bankruptcy court's confirmation of a Chapter 11 plan, over the objection of the UST, even though one of the debtors had a tenant who was involved in a marijuana growing operation. But *Garvin* involved only a narrow issue of law that is not before this Court. The issue was whether the debtors' plan met the confirmation requirement in [11 U.S.C. § 1129\(a\)\(3\)](#), that the plan be "proposed . . . not by any means forbidden by law." The court of appeals held that this provision in [§ 1129\(a\)\(3\)](#) applies only to the "means of a reorganization plan's proposal, not its substantive provisions." [Garvin, 2019 U.S. App. LEXIS 13235, 2019 WL 1945280, at *1, 3](#) (italics in original). Thus, the court held that the quoted prong of [§ 1129\(a\)\(3\)](#) was not violated by the substance of the confirmed plan, including the debtor's continuing to lease its building to a marijuana grower in violation of federal law.

In *Garvin*, earlier in the bankruptcy case, before the plan was confirmed by the bankruptcy court, the UST had filed a motion to dismiss, based on the one debtor's leasing to a marijuana grower. The dismissal motion argued that "cause" existed to dismiss that debtor's case, because of "gross mismanagement of the estate" by the debtor, within the meaning of [11 U.S.C. § 1112\(b\)\(4\)\(B\)](#). [2019 U.S. App. LEXIS 13235, 2019 WL 1945280, at *2](#). The bankruptcy court denied that dismissal motion, "but with leave to renew [it] at the plan confirmation hearing." [Garvin, 2019 U.S. App. LEXIS 13235, 2019 WL 1945280, at *2](#). But the UST failed to renew its dismissal motion at the confirmation hearing, and instead argued only its objection to confirmation based on [§ 1129\(a\)\(3\)](#). In affirming confirmation of the debtors' plan, the court of appeals ruled that the UST waived its dismissal motion argument under [§ 1112\(b\)](#). For this reason, the court of appeals refused to address that issue.

The decision of the Ninth Circuit Court of Appeals in *Garvin* is not binding on this Court, and, with respect, this Court does not necessarily agree with the *Garvin* court's holding about [§ 1129\(a\)\(3\)](#). And, respectfully, one might reasonably question whether the *Garvin* court should have refused to decide the [§ 1112\(b\)](#) dismissal issue. That refusal, on waiver grounds, arguably is questionable, because it allowed the affirmance, by a *federal* court, of the confirmation of a Chapter 11 plan under which a debtor would continue to violate *federal* criminal

[*382] 3. This case

a. "Cause" exists under [§ 1112\(b\)\(1\)](#) to dismiss or convert this case.

The UST argues that the Debtor has filed and is pursuing this bankruptcy case with unclean hands, because the Debtor's purpose is not to disentangle from any marijuana-based business, but rather to enable its owner to profit from a marijuana business. The UST argues that the Debtor's real purpose is to use this bankruptcy case to help enable the Debtor's 100% shareholder, Weaam Nocha, to **[**24]** obtain a better marijuana-based deal than what is provided by the November Lease and the State Court Decision.

The Debtor denies that it has unclean hands. The Debtor says that it wants to disentangle itself from the November Lease, by rejecting that lease. The Debtor insists that it does not want to be involved in the marijuana business, but rather just wants to try to reorganize its custom cabinet business, and continue doing that business, at its existing location.

But this Court is bound to reject these assertions by the Debtor. It is clear and obvious to this Court, from the findings and conclusions in the State Court Decision, that the Debtor's sole shareholder, Weaam Nocha, caused the Debtor to file this bankruptcy case for the sole purpose of evading the State Court Decision, and avoiding the enforcement of the November Lease, so that Weaam Nocha does not have to sell the Nocha Property to MJCC for only \$1.2 million. Weaam Nocha obviously wants to realize more money for himself, as owner of the Nocha Property, than what the enforcement of the State Court Decision will give him, either by (1) renting or selling the Nocha Property to MJCC, or to some other marijuana dispensary **[**25]** business, for a higher rent or a higher sale price than \$1.2 million; or (2) using the property to operate a marijuana dispensary himself, as he started to do with the help of his immediate family members before the State Court Decision was issued. Weaam Nocha did not cause the Debtor to file this bankruptcy case for the benefit of the Debtor or the Debtor's creditors, but rather solely for his own benefit — a benefit that depends on activity that is illegal under the CSA.

Borrowing from the words used by the UST in its

law under the CSA.

motion, Weaam Nocha wants to use this bankruptcy case "to set aside this illegal contract [*i.e.*, the November Lease] so that he can negotiate a better illegal contract."³⁹

Under Weaam Nocha's control, the Debtor denies these things. But these denials are precluded by the State Court Decision's findings and conclusions. The Debtor and Weaam Nocha both are bound by the findings and conclusions in the State Court Decision, under the doctrine of collateral estoppel. That means that they are precluded from now making assertions that are contrary to the findings and conclusions of the State Court Decision. And those findings and conclusions, described in Part III.C of this Opinion, **[**26]** inescapably lead to this Court's conclusions of what that the actual purpose of this bankruptcy case is.

The assertion that the Debtor, Weaam Nocha, and his family do not want the Nocha Property to be used or involved in the marijuana business, especially, is belied **[*383]** by the state court's detailed findings about all the efforts Weaam Nocha and his family went to in order to operate their own marijuana dispensary business at the Nocha Property, after refusing to honor the November Lease with MJCC. And then, only nine days after losing the State Court Lawsuit, Weaam Nocha caused the Debtor to file this bankruptcy case (1) to try to "reject" the November Lease under [Bankruptcy Code § 365](#); and (2) to try to obtain the benefit of the automatic stay to delay MJCC's obtaining ownership of the Nocha Property while Weaam Nocha, the Debtor, and the other state court defendants appeal the State Court Decision.

The actual purpose of filing and prosecuting this bankruptcy case is for the Debtor and its 100% shareholder to use this bankruptcy court, and the Bankruptcy Code, to assist them in obtaining a result that is contrary to federal criminal law under the Controlled Substances Act, and therefore contrary to federal **[**27]** public policy.

This federal court cannot allow itself to be used in this way. The Court finds that the Debtor has unclean hands, and that there is "cause" to dismiss or convert this case, under [11 U.S.C. § 1112\(b\)\(1\)](#).

b. There is no practical alternative to dismissal

³⁹ UST Mot. (Docket # 30) at 1.

Having found that cause exists to dismiss or convert this case under [§ 1112\(b\)\(1\)](#), the Court next must determine which of these choices is "in the best interests of creditors and the estate."⁴⁰ The Court finds that dismissal, rather than conversion to Chapter 7, is in the best interests of creditors and the estate, for the following reasons.

First, a conversion to Chapter 7 would mean a liquidation of the Debtor, and the termination of the Debtor's business of manufacturing and installing custom cabinets. The Debtor does not want to liquidate in Chapter 7. Rather, the Debtor has expressed a desire to continue operating its custom cabinets business, even though that business is relatively small,⁴¹ and there is no reason to think that the Debtor cannot continue to operate its custom cabinets business outside of bankruptcy. Nor has any creditor of the Debtor advocated for the conversion and liquidation of the Debtor in Chapter 7. There is no reason to think that **[**28]** a liquidation of the Debtor in Chapter 7 is in the best interests of the creditors or the estate.

Second, like the court in the *Way to Grow* case, discussed in Part III.F.2 of this Opinion, this Court sees "no practical alternative to dismissal" in this case. See [Way to Grow, 597 B.R. at 132](#). Conversion is not a practical alternative. As discussed in Part III.E of this Opinion, the Court has ruled that the Debtor cannot reject (or **[*384]** assume) the November Lease under [§ 365\(a\)](#), because that lease is not a lease or executory contract "of the debtor." That ruling will thwart the bankruptcy strategy in this case of the Debtor and its

⁴⁰ No one has argued that it is in the best interests of the creditors and the estate to appoint a Chapter 11 trustee under [11 U.S.C. § 1104\(a\)](#) or to appoint an examiner. See [11 U.S.C. § 1112\(b\)\(1\)](#). The Court finds that neither of these choices is in the best interests of the creditors and the estate. This is so because neither of these options would serve any useful purpose in this case, and also for the same reasons why dismissal, rather than conversion, is in the best interests of the creditors and the estate, as discussed below. So the choice under [§ 1112\(b\)\(1\)](#) is between dismissal and conversion.

⁴¹ The Debtor's monthly operating reports filed in this case show that the Debtor's income from its custom cabinets business is rather small. These reports show that the Debtor's total income was zero for the partial month of December 16-31, 2018 (Docket # 31 at 2); \$16,000.00 in January 2019 (Docket # 62 at 2); \$48,500.00 in February 2019 (Docket # 91 at 2); \$10,000.00 in March 2019 (Docket # 103 at 2), and \$13,000.00 in April 2019 (Docket # 112 at 2).>

owner, Weaam Nocha. But even with that ruling, the continued pendency of this bankruptcy case, whether in Chapter 11 or in Chapter 7, creates an impossible situation for this Court.

One major problem has to do with the automatic stay. After this Court's ruling on the Debtor's Lease Rejection Motion, Weaam Nocha will be forced by the state court, under the State Court Decision, to sell the Nocha Property to MJCC, and MJCC then will become the owner of that property. As owner, MJCC will have the exclusive right to possession of the Nocha Property, under Michigan law. But the Debtor operates **[**29]** its custom cabinet business from that property, and currently is in sole possession of that property. While this bankruptcy case remains pending, under either Chapter 11 or Chapter 7, the automatic stay will prevent MJCC from taking any action to wrest away possession of the Nocha Property from the Debtor, even after MJCC becomes the owner of the Nocha Property. See, e.g., [11 U.S.C. §§ 362\(a\)\(1\), 362\(a\)\(3\)](#),⁴² [Convenient Food Mart No. 144, Inc. v. Convenient Indus. of Am., Inc. \(In re Convenient Food Mart No. 144, Inc.\)](#), 968 F.2d 592, 594 (6th Cir. 1992) (holding that a bankruptcy debtor in possession of real estate, which has no right to possession, but which has a "tenancy at sufferance" under Kentucky law, has a "possessory interest in real property" that is protected by the automatic stay); [Chrysler LLC v. Plastech Engineered Prods., Inc. \(In re Plastech Engineered Prods., Inc.\)](#), 382 B.R. 90, 106 (Bankr. E.D. Mich. 2008) (holding that even a bankruptcy debtor's "bare possessory interest" in certain tooling was protected by the automatic stay, under [11 U.S.C. § 362\(a\)\(3\)](#)).

In a normal case, when a bankruptcy debtor is in possession of real property that belongs to another person, and the debtor has no right to possession of that property under applicable non-bankruptcy law, it might be relatively easy for the owner of the property to file a motion seeking relief from the automatic stay, and obtain **[**30]** such relief. Such relief from the stay would be to permit that owner to prosecute an eviction action

⁴² Under [§ 362\(a\)\(1\)](#), the filing of the bankruptcy petition in this case operates as a stay, among other things, of the "commencement or continuation . . . of a judicial . . . action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title." Under [§ 362\(a\)\(3\)](#), the automatic stay prevents, among other things, "any act to obtain possession" not only of "property of the estate," but also of "property **from** the estate." (emphasis added).

in an appropriate non-bankruptcy court, to obtain possession of the property. (MJCC has filed a motion for relief from stay in this case.)

But this is not a normal case. In this case, the Court likely would have to refuse to grant any stay relief, or any other relief, requested by MJCC, because MJCC also has unclean hands. The granting of stay relief to MJCC obviously would assist MJCC in its efforts to open and operate a medical marijuana dispensary, in violation of federal law. Just as "a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime," [Rent-Rite](#), 484 B.R. at 805 (footnote omitted), neither can a federal court be asked to enforce any *creditor* protections under the Bankruptcy Code, such as the relief-from-stay provisions of [11 U.S.C. § 362\(d\)](#), in aid of a *creditor's* commission of a federal crime.

This Court is unwilling and unable to assist a party like MJCC to violate federal **[*385]** law. So this Court likely would not grant stay relief to MJCC, even after MJCC became the owner of the Nocha Property.

Thus, the continuation of this **[**31]** bankruptcy case, under either Chapter 11 or Chapter 7, would leave the Court and the parties stuck in the middle of a continuing tug-of-war between two parties with unclean hands (the Debtor and MJCC), with the Court unable and unwilling to grant relief to either party. To use a metaphor employed by the UST, the only practical solution is to "cut the Gordian knot,"⁴³ by dismissing this case. Such dismissal is available here, at the request of a party that does *not* have unclean hands — the UST. And dismissal will leave the Debtor, Weaam Nocha, and MJCC to continue their battles in the state court, where those battles belong.

So the Court will dismiss this bankruptcy case. And in order to prevent any attempted evasion by anyone of the Court's decisions today, the Court will bar the filing of any new bankruptcy case, by or against the Debtor, for a period of two years. This should give ample time for the Debtor's pending state court appeal to conclude. Imposing this bar to a new bankruptcy filing is within the Court's discretion and authority, under [11 U.S.C. § 105\(a\)](#), and also under [11 U.S.C. § 349\(a\)](#). See [In re Packard Square LLC](#), 575 B.R. 768, 783 (Bankr. E.D. Mich. 2017); [In re Packard Square LLC](#), 577 B.R. 533,

⁴³ See UST Suppl. Br. (Docket # 96) at 2.

[537-38 \(Bankr. E.D. Mich. 2017\)](#), *aff'd.*, [586 B.R. 853 \(E.D. Mich. 2018\)](#); *In re Skymark Properties II, LLC*, [597 B.R. 391, 403 \(Bankr. E.D. Mich. 2019\)](#).

G. Discussion of the Stay Relief Motion

The Court's decision to dismiss this bankruptcy case will make **[**32]** MJCC's Stay Relief Motion moot. The automatic stay will terminate upon the dismissal of this case. See [11 U.S.C. §§ 362\(c\)\(1\)](#) and [362\(c\)\(2\)\(B\)](#). So the Court will deny the Stay Relief Motion, as moot.

IV. Conclusion

For the reasons stated in this Opinion, the Court will enter orders (1) denying the Debtor's Lease Rejection Motion; (2) granting the UST's Dismissal Motion, and dismissing this case, with a two-year bar to refiling; and (3) denying the Stay Relief Motion, as moot.

Signed on May 21, 2019

/s/ Thomas J. Tucker

Thomas J. Tucker

United States Bankruptcy Judge

End of Document

In re Way to Grow, Inc.

United States Bankruptcy Court for the District of Colorado

December 14, 2018, Decided

Case No. 18-14330 MER, Case No. 18-14334 MER, Case No. 18-14333 MER, Chapter 11, Jointly Administered
Under Case No. 18-14330

Reporter

597 B.R. 111 *; 2018 Bankr. LEXIS 4142 **

In re: WAY TO GROW, INC., PURE AGROBUSINESS, INC., GREEN DOOR AGRO, INC., Debtors.

Counsel: **[**1]** For James Blaha, Blue Moose, LLC, Creditors (1:18bk14330): Joshua M. Hantman, Denver CO.

For Corey Inniss, Creditor (1:18bk14330): Annette W Jarvis, Salt Lake City UT; Gregory S. Tamkin, Denver CO; Andrea Ahn Wechter, Denver CO.

For Susan Inniss, Creditor (1:18bk14330): Joshua M. Hantman, Denver CO.

For Dean/Carson South Platte, LLC, Creditor (1:18bk14330): Kevin S. Neiman, Denver CO.

For Pension Benefit Guaranty Corporation, Creditor (1:18bk14330): Rhonda Baird, Washington DC.

For Boscoe Children, L.L.L.P., Creditor (1:18bk14330): Amanda Holland Halstead, Denver CO.

For Isuzu Finance of America, Inc., Creditor (1:18bk14330): Dennis A. Dressler, Chicago IL.

For Cheyenne Avenue Holdings, LLC, Creditor (1:18bk14330): Timothy M. Swanson, Denver CO.

For Hawthorne Hydroponics LLC Markus Williams & Young Llc, Creditor (1:18bk14330): Matthew T. Faga, Denver CO.

For Red Fisch, LLC, Creditor (1:18bk14330): Barry L. Wilkie, Denver CO.

For Green Door Agro Inc., a California corporation, Pure Agrobusiness, Inc., a Nevada corporation, Way To Grow, Inc., a Colorado corporation, Debtors (1:18bk14330): Lee M. Kutner, Lead Attorney, Denver CO; Keri L. Riley, Denver CO.

For Byron G. Rogers Federal Building, US **[**2]** Trustee (1:18bk14330): Robert Samuel Boughner, Byron G. Rogers Federal Building, Denver CO.

For Pure Agrobusiness, Inc., a Nevada corporation, Debtor (18-14334-MER): Lee M. Kutner, Keri L. Riley,

Denver, CO.

For US Trustee, U.S. Trustee (18-14334-MER): Robert Samuel Boughner, Denver, CO.

For Green Door Agro Inc., a California corporation, Debtor (18-14333-MER): Lee M. Kutner, Keri L. Riley, Denver, CO.

For US Trustee, U.S. Trustee (18-14333-MER): Robert Samuel Boughner, Denver, CO.

Judges: Honorable Michael E. Romero, Chief United States Bankruptcy Judge.

Opinion by: Michael E. Romero

Opinion

[*114] ORDER

THIS MATTER comes before the Court upon the Motion to Dismiss or Abstain¹ filed by Secured Creditor Corey Inniss ("**Inniss**"); the Objection to the Motion to Dismiss² filed by Debtors Way to Grow, Inc., Pure Agrobusiness, Inc. and Green Door Agro, Inc. ("**Debtors**"); Inniss's Reply in support of the Motion to Dismiss;³ and the Debtors' Response to the Reply.⁴ The Court held a four day evidentiary hearing on the Motion to Dismiss on October 15-16, 2018, and November 8-9, 2018.

BACKGROUND

¹ ECF No. 93 ("**Motion to Dismiss**").

² ECF No. 122 ("**Objection**").

³ ECF No. 139 ("**Reply**").

⁴ ECF No. 166 ("**Response**").

As of the Petition Date, Way to Grow, Inc. ("**Way to Grow**") and Green Door Agro, Inc. ("**Green Door**") owned and **[**3]** operated seven retail outlets in Colorado and an internet sales presence. Green Door has a sales facility in California. Way to Grow and Green Door are both subsidiaries of Pure Agrobusiness, Inc. ("**Pure Agro**"). Pure Agro also owns 100% of a non-debtor affiliate, Crop Supply, Inc., which caters to the Debtors' commercial clients, but is funded by Debtors.⁵ Richard Byrd ("**Byrd**") is the owner and principal manager of the Debtors.

Debtors' business involves the sale of equipment for indoor hydroponic and gardening-related supplies. As to their customers' **[*115]** uses of their products, Debtors have represented "[w]hile the hydroponic gardening equipment may and is used for many types of crops, the Debtors' future business expansion plan is tied to the growing cannabis industry which is heavily reliant on hydroponic gardening."⁶

Byrd acquired ownership and control of the Debtors through a sale transaction with Inniss, who founded Way to Grow in Colorado in 2002. During Inniss's ownership, Way to Grow grew from a single store in Fort Collins to a chain of seven retail stores throughout Colorado's Front Range. Several of the Debtors' seven storefronts were in locations leased to the Debtors by Susan **[**4]** Inniss, the mother of Corey Inniss. James Blaha ("**Blaha**"), Susan Inniss's former husband, also leased a location to the Debtors through his wholly-owned entity, Blue Moose, LLC ("**Blue Moose**").

The events leading to this bankruptcy case began on January 1, 2016, when Byrd and Inniss entered into an agreement for the sale of Way to Grow ("**Purchase Agreement**").⁷ As set forth in Section 2.2 of the Purchase Agreement, the consideration for the sale consisted of: 1) a cash payment to Inniss of \$2,500,000; 2) a secured promissory note to Inniss ("**Note**") for the principal amount of \$22,500,000; and 3) 12,500,00 shares of Byrd's common stock in Pure Agro, Debtors' holding company, with a par value of \$0.001.⁸ According to Debtors' Amended Schedules and Statement of Financial Affairs, Inniss owns approximately 21.26% of the stock in Pure Agro.⁹

⁵ Exh. E p. 15.

⁶ Exh. 3, at ¶ 1.

⁷ Exh. 8.

⁸ *Id.* at ¶ 2.2.

Pursuant to Section 3 of the Note, Debtors' pledged collateral securing its obligations to Inniss consists of "any and all property and assets" of the Debtors, including after-acquired property, accounts receivable and inventory.¹⁰

A short time after the sale closed, on April 6, 2018, Inniss, individually and derivatively on behalf of Pure Agro as a shareholder, filed a complaint **[**5]** against the Debtors and Byrd in the District Court for Larimer County, Colorado.¹¹ On April 9, 2018, Inniss moved to appoint a receiver over Pure Agro and its subsidiaries in the State Case, seeking to oust Byrd as the Debtors' manager. Debtors filed bankruptcy before a receiver was appointed.

Because Debtors filed this bankruptcy in the face of a receivership, Inniss argues this case is no more than a continuation of the two-party dispute between Inniss and Debtors arising from the pending receivership proceedings. Inniss asserts this Court should dismiss or abstain from these bankruptcy proceedings in favor of allowing the State Case to proceed through conclusion.

From the beginning of this case, Debtors represented an intent to reorganize by rejecting over-market leases and otherwise reducing expenses. Through August 2018, Debtors' Monthly Operating Reports disclosed cumulative net cash flow of \$109,320 on revenues of \$2,027,246 and expenses of \$1,917,928.¹² Meanwhile, Debtors' profit and loss statements reveal a total net operating loss of \$607,865 through August 2018.¹³

Inniss argues these net operating losses, together with other financial performance issues, constitute violations **[**6]** of this Court's orders on the Debtors' use of Inniss's cash collateral. In response, Debtors maintain **[*116]** their gradual progress towards reorganization, including rejecting over-market leases, will result in significant savings not yet reflected in its financial disclosures. It is true during the case, Debtors rejected four leases for its Colorado retail locations in Lakewood, Colorado Springs, Pueblo, and Fort Collins,

⁹ Exh. E, p. 11.

¹⁰ Exh. A, ¶ 3.

¹¹ Case No. 2018CV30331 ("**State Case**").

¹² Exh. EE, p. 2.

¹³ *Id.* at p. 11.

and closed its location in Silverthorne.¹⁴ A motion to reject one of Debtors' Denver leases remains pending.¹⁵ One of Debtors' store managers also testified Debtors reduced their workforce as part of its cost-saving measures.

These first two issues — Debtors' alleged violations of the cash collateral order and the purported two-party nature of the dispute — are essentially secondary issues to the main event, namely, the Debtors' connections to the marijuana industry. As discussed extensively below, bankruptcy courts nationwide have wrestled with the issue whether companies connected to marijuana businesses legal under state law are eligible for bankruptcy protection, where those connections constitute continuing violations of federal law.

ANALYSIS

A. LEGAL FRAMEWORK FOR MARIJUANA [7] RELATED BANKRUPTCY CASES**

Pursuant to the Controlled Substances Act of 1970 ("CSA"),¹⁶ marijuana¹⁷ is designated a Schedule I controlled substance under federal law.¹⁸ Therefore, under the CSA, it is a federal crime to "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance[.]"¹⁹ Further, the CSA prohibits any person from possessing or distributing "any equipment . . . product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to

manufacture a controlled substance" in violation of federal law.²⁰ The CSA also expressly provides any person who "conspires to commit any offense" under the CSA shall be subject to the same penalties as the principal.²¹

Notwithstanding the absolute federal prohibition on the use, sale or cultivation of marijuana, several states, including Colorado, have legalized marijuana for both medical and recreational use.²² In *Gonzales v. Raich*, the U.S. Supreme Court definitively held the federal government's designation of marijuana as a controlled substance supersedes contrary state law through application [**8] of the *commerce clause*.²³ [**117] As a result, there remains an ever-shifting landscape of federal enforcement of marijuana criminalization where the same activity is fully legal under state law.²⁴

Of course, bankruptcy laws and bankruptcy courts are purely creatures of federal law. Accordingly, bankruptcy courts have consistently dismissed cases where debtors engaged in ongoing CSA violations, or where a debtor's reorganization efforts depend on funds which can be considered proceeds of CSA violations.

The seminal case on the issue from this District is Judge Howard Tallman's (Ret.) decision in *In re Rent-Rite Super Kegs West Ltd.*²⁵ There, the court considered a motion to dismiss a Chapter 11 case in which the debtor derived 25% of its revenue from leasing warehouse

¹⁴ See ECF Nos. 151, 244, 333 and 335. Debtors filed a motion to reject the lease for their location in Silverthorne at ECF No. 51, but an order on that motion does not appear on the docket. However, Byrd testified at trial the Silverthorne location has been closed.

¹⁵ ECF No. 336.

¹⁶ Unless otherwise specified, all references herein to "Section," "§," and "CSA" refer to Title [21 U.S.C. § 101, et seq.](#)

¹⁷ The CSA refers to cannabis and marijuana products as "marihuana."

¹⁸ [§ 812](#).

¹⁹ [§ 841\(a\)\(1\)](#).

²⁰ [§ 843\(a\)\(6\)](#) refers to possession of drug manufacturing equipment while [§ 843\(a\)\(7\)](#) refers to distribution of such equipment. As discussed in detail below, the *scienter* required for conviction under either sub-section is the same.

²¹ [§ 846](#).

²² See [Colo. Const., Art. XVIII, Sections 14](#) and [16](#) (legalizing marijuana for medical and recreational use, respectively).

²³ [Gonzales v. Raich, 545 U.S. 1, 125 S. Ct. 2195, 162 L. Ed. 2d 1 \(2005\)](#).

²⁴ See, e.g., James M. Cole, Deputy Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: GUIDANCE REGARDING MARIJUANA ENFORCEMENT (Aug. 29, 2013) (commonly known as the "**Cole Memo**"); *but see* Jeffrey B. Sessions, Attorney General, MEMORANDUM FOR ALL UNITED STATES ATTORNEYS: MARIJUANA ENFORCEMENT (January 4, 2018) (revoking Cole Memo).

²⁵ [484 B.R. 799 \(Bankr. D. Colo. 2012\)](#).

space to marijuana businesses.²⁶ Finding this activity plainly prohibited under [§ 856\(a\)](#), the court concluded the debtor was in continuing violation of federal law during its bankruptcy case.²⁷ Analyzing Colorado's legal framework for marijuana legalization, Judge Tallman noted Colorado **[**9]** law "make[s] it clear that their provisions apply to state law only. Absent from either enactment is any effort to impede the enforcement of federal law."²⁸ Accordingly, the court concluded:

[E]ven if the Debtor is never charged or prosecuted under the CSA, it is conducting operations in the normal course of its business that violate federal criminal law. Unless and until Congress changes that law . . . a federal court cannot be asked to enforce the protections of the Bankruptcy Code in aid of a Debtor whose activities constitute a continuing federal crime.²⁹

As additional grounds for dismissal, Judge Tallman further concluded the debtor was barred from bankruptcy relief by the clean hands doctrine:

The Debtor freely admits that it leases space to those who are engaged in the cultivation of marijuana. Even if the Debtor's [*sic*] holds a good faith — albeit misguided — belief that Colorado state law would prevail over the federal law or that the federal law is unlikely to be enforced, that is quite beside the point. The Debtor has knowingly and intentionally engaged in conduct that constitutes a violation of federal criminal law and it has done so with respect to its sole income producing **[**10]** asset.³⁰

Based on these conclusions, the *Rent-Rite* court found it necessary to dismiss the bankruptcy case pursuant to [11 U.S.C. § 1112\(b\)](#).³¹

Two years later, in *In re Arenas*, Judge Tallman expanded the holding of *Rent-Rite* to dismiss a bankruptcy case where the bankruptcy trustee would be

required to administer marijuana-related assets.³² **[*118]** In *Arenas*, the debtors, who operated a marijuana grow facility, filed for relief under Chapter 7 of the Bankruptcy Code. A Chapter 7 trustee was appointed in the ordinary course.³³ The Office of the United States Trustee ("UST") moved to dismiss. Assessing the ability of a Chapter 7 trustee to administer marijuana assets, Judge Tallman reasoned:

Here, the Debtors' chapter 7 trustee cannot take control of the Debtors' Property without himself violating [§ 856\(a\)\(2\)](#) of the CSA. Nor can he liquidate the inventory of marijuana plants Mr. Arenas possessed on the petition date because that would involve him in the distribution of a Schedule I controlled substance in violation of [§ 841\(a\)](#) of the CSA. The Court finds that administration of this case under chapter 7 is impossible without inextricably involving the Court and the Trustee in the Debtors' ongoing criminal violation of the CSA. . . . To allow the Debtors to remain in a chapter 7 **[**11]** bankruptcy case under circumstances where their Trustee is unable to administer valuable assets for the benefit of creditors would allow them to receive discharges without turning over their non-exempt assets to the Trustee. That would give the Debtors all of the benefits of a chapter 7 bankruptcy discharge while allowing them to avoid the attendant burdens. The impossibility of lawfully administering the Debtors' bankruptcy estate under chapter 7 constitutes cause for dismissal of the Debtors' case under [11 U.S.C. § 707\(a\)](#).³⁴

The *Arenas* debtors further sought to avoid dismissal by seeking to convert their case from Chapter 7 to Chapter 13. Denying that request, the court concluded the debtors' plan payments would necessarily be funded by proceeds of a criminal enterprise under federal law, and therefore conversion was not in good faith.³⁵ The court reasoned a plan could not be administered by a Chapter 13 trustee who would be prohibited from receiving or

²⁶ *Id.*

²⁷ [Id. at 810.](#)

²⁸ [Id. at 806.](#)

²⁹ [Id. at 805.](#)

³⁰ [Id. at 807.](#)

³¹ [Id. at 811.](#)

³² [514 B.R. 887 \(Bankr. D. Colo. 2014\).](#)

³³ *Id.*

³⁴ [Id. at 891.](#)

³⁵ [Id. at 894.](#)

distributing funds derived from CSA violations.³⁶

On appeal, the Bankruptcy Appellate Panel for the Tenth Circuit ("**BAP**") affirmed Judge Tallman's opinion dismissing the Arenas' bankruptcy case.³⁷ The question presented to the BAP was whether "a debtor [****12**] in the marijuana business [can] obtain relief in the federal bankruptcy court?"³⁸ The BAP answered this question with a resounding "No."

The BAP agreed with Judge Tallman "that while the debtors have not engaged in intrinsically evil conduct, the debtors cannot obtain bankruptcy relief because their marijuana business activities are federal crimes."³⁹ Applying the eleven factors to determine good faith set forth by the U.S. Court of Appeals for the Tenth Circuit in *Flygare v. Boulden*,⁴⁰ the BAP [***119**] agreed the debtors could not show an employment history to support future income unrelated to marijuana, the trustee could not legally administer and distribute marijuana derived assets, and, while their motives were not improper, the debtors were not acting in good faith according to an objective standard.⁴¹ That is, the inability to propose a confirmable plan made it "objectively unreasonable" for the debtors to seek Chapter 13 relief.⁴²

³⁶ *Id.*

³⁷ [535 B.R. 845 \(10th Cir. BAP 2015\)](#)

³⁸ [Id. at 847.](#)

³⁹ [Id. at 849-50.](#)

⁴⁰ [709 F.2d 1344 \(10th Cir. 1983\)](#) (the ten factors are "(1) the amount of the proposed payments and the amount of the debtor's surplus; (2) the debtor's employment history, ability to earn and likelihood of future increases in income; (3) the probable or expected duration of the plan; (4) the accuracy of the plan's statements of the debts, expenses and percentage repayment of unsecured debt and whether any inaccuracies are an attempt to mislead the court; (5) the extent of preferential treatment between classes of creditors; (6) the extent to which secured claims are modified; (7) the type of debt sought to be discharged and whether any such debt is non-dischargeable in Chapter 7; (8) the existence of special circumstances such as inordinate medical expenses; (9) the frequency with which the debtor has sought relief under the Bankruptcy Reform Act; (10) the motivation and sincerity of the debtor in seeking Chapter 13 relief; and (11) the burden which the plan's administration would place upon the trustee.").

Finally, the BAP addressed the Arenas' argument the case should not be *per se* dismissed or converted, but rather, the trustee should simply abandon the marijuana assets:

It is not clear that a bankruptcy court may order a trustee to abandon assets *sua sponte*. And even [****13**] if the court can do that, this bankruptcy estate, shorn of its marijuana assets, would likely yield no dividend to the creditors. The debtors would get a discharge and get to keep (via abandonment) their marijuana assets while being protected from collection activities. This also strikes us as prejudicial delay that amounts to cause for dismissal.⁴³

This Court addressed a marijuana-related issue only once, in *B Fischer Industries, LLC*.⁴⁴ There, debtor manufactured allegedly knowingly sold butane for use in manufacturing marijuana concentrates.⁴⁵ The Court dismissed the bankruptcy case on March 8, 2017, on the debtor's motion. However, a creditor pursued a motion for sanctions relating to the bankruptcy filing and the Court retained jurisdiction for purposes of adjudicating the creditor's motion.⁴⁶ A discovery dispute arose requiring the Court to analyze the applicability of the crime-fraud exception to the attorney-client privilege where the alleged crime involves a marijuana-related offense.⁴⁷ Relevant to the issues in this case, the Court in *B. Fischer* found debtor's pre-petition sale of butane "*may*" have violated the CSA, but regardless, the inquiry should not focus strictly on pre-petition [****14**] activities.⁴⁸ Rather, the focus should be on the time wherein debtor sought bankruptcy relief and thereafter.⁴⁹

⁴¹ [535 B.R. at 852-53.](#)

⁴² *Id.*

⁴³ [Id. at 854.](#)

⁴⁴ *In re B Fischer Industries, LLC*, No. 16-20863-MER, ECF No. 147 (Bankr. D. Colo. Sept. 27, 2017).

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

On a post-petition basis, the Court concluded it could not find the debtor's sales of butane to a pass-through non-debtor affiliate necessarily violated the CSA.⁵⁰ Of course, this was the correct inquiry as pertaining to a potential exception to the attorney-client privilege, but, nonetheless, the Court agreed "a debtor's pre-petition involvement in the marijuana industry is not a *per se* bar to relief under [*120] the Bankruptcy Code."⁵¹ Finding the creditor failed to meet her burden of establishing the debtor's violation of the CSA, the Court denied her crime-fraud motion.⁵²

Taken together, the decisions in *Rent-Rite*, *Arenas* and *B. Fischer* elucidate three basic propositions. First, a party cannot seek equitable bankruptcy relief from a federal court while in continuing violation of federal law. Second, a bankruptcy case cannot proceed where the court, the trustee or the debtor-in-possession will necessarily be required to possess and administer assets which are either illegal under the CSA or constitute proceeds of activity criminalized [**15] by the CSA. And third, the focus of this inquiry should be on debtor's marijuana-related activities during the bankruptcy case, not necessarily before the bankruptcy case is filed.

Certainly, many other bankruptcy courts in marijuana-legalization states have addressed similar issues and, for the most part, have reached similar conclusions.

In *In re McGinnis*,⁵³ debtor proposed Chapter 13 plan to be funded by: 1) a business leasing a warehouse to a marijuana grower; 2) the debtor's own marijuana grow operation; and 3) rental income from property housing tattoo artists.⁵⁴ Because the plan was to be funded through operations dependent "on a product the cultivation and sale of which violates federal law[.]" the court held the plan was proposed by means forbidden by law and could not be confirmed pursuant to [11 U.S.C. § 1325\(a\)\(3\)](#).⁵⁵ Further, due to the federal illegality of the operations, the court found "the predicted

income stream from the marijuana operations is [not] reasonably certain to produce sufficient income to fund the Plan[.]" and therefore concluded the plan failed the feasibility requirement of [11 U.S.C. § 1325\(a\)\(6\)](#).⁵⁶

In *Northbay Wellness Group v. Beyries (In re Beyries)*, plaintiff sold medical marijuana.⁵⁷ Debtor was their attorney. [**16]⁵⁸ Plaintiff sought a non-dischargeability judgment based on the attorney's knowing misrepresentations concerning plaintiff's sales tax obligations.⁵⁹ While the court held the debt met the elements of [11 U.S.C. § 523\(a\)\(4\)](#), the court ruled it could not enter a judgment for plaintiff because they engaged in unlawful activity.⁶⁰ Even though the activity was legal under state law, in a federal court the parties were "conspiring to sell contraband."⁶¹ The court found the plaintiff *in pari delicto* and dismissed the adversary.⁶²

On appeal, the U.S. Court of Appeals for the Ninth Circuit reversed and remanded the bankruptcy court's order dismissing the adversary.⁶³ The Ninth Circuit determined the parties' engagement in a marijuana business did not automatically [*121] require application of *in pari delicto*.⁶⁴ Instead, *in pari delicto* requires a balancing test of the parties' respective wrongdoing.⁶⁵ Had the bankruptcy court properly conducted the required balancing test, the Ninth Circuit would have concluded the debtor's wrongdoing outweighed the plaintiff's. Debtor misappropriated client trust funds, and could not escape liability for that theft through a bankruptcy discharge simply because the

⁵⁶ *Id.* at 773.

⁵⁷ [No. 10-1181, 2011 Bankr. LEXIS 4710, 2011 WL 5975445 \(Bankr. N.D. Cal. Nov. 29, 2011\)](#).

⁵⁸ *Id.* at *1.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.* at *2.

⁶² *Id.*

⁶³ [789 F.3d 956 \(9th Cir. 2015\)](#).

⁶⁴ *Id.* at 959-60.

⁶⁵ *Id.* at 960.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ [453 B.R. 770 \(Bankr. D. Or. 2011\)](#).

⁵⁴ *Id.* at 771.

⁵⁵ *Id.* at 772.

creditor-plaintiff's business **[**17]** is marijuana.⁶⁶

*In re Medpoint Management LLC*⁶⁷ involved an involuntary Chapter 7 petition filed against a medical marijuana business. The debtor's assets consisted entirely of marijuana products and related intellectual property.⁶⁸ The petitioning creditors' claims arose from credit extended or services knowingly provided in furtherance of debtor's marijuana business. Upon debtor's opposition to an order for relief, the court dismissed the involuntary bankruptcy case.⁶⁹ The court reasoned the possibility of forfeiture of the debtor's marijuana assets pursuant to CSA imposed an unacceptable risk to a Chapter 7 estate and trustee.⁷⁰ Further, the court held it could not issue an order for relief which would effectively order a Chapter 7 trustee to possess and administer assets in violation of federal law.⁷¹ The court also found the petitioning creditors were not eligible to file the involuntary petition because of *in pari delicto*. The creditors knew the debtor was in the marijuana business, voluntarily chose to engage in that business with them, and therefore had unclean hands precluding them from petitioning a federal court for relief.⁷² Finally, the court declined to sanction the creditors, finding **[**18]** no bad faith in filing the involuntary petition, because the marijuana business presented a novel issue, and the debtor appeared insolvent and properly in bankruptcy but for the marijuana issue.⁷³

In *In re Johnson*,⁷⁴ a Chapter 13 debtor was a licensed "caregiver" and marijuana grower operating legally under Michigan law. The UST filed a motion to dismiss. Debtor's income was \$1,203 per month from social security and \$1,000 per month from his marijuana

business.⁷⁵ First, the court noted all federal judges take an oath to uphold federal law, and allowing a marijuana case to proceed in federal court violates this oath.⁷⁶ No matter what precautions were taken, allowing the case to remain in bankruptcy would result in both trustee and the court supporting the debtor's criminal enterprise.⁷⁷ Second, the court looked to [28 U.S.C. § 959\(b\)](#), which prohibits federal officers from holding contraband or proceeds or instrumentalities of federal criminal activity.⁷⁸ The court held this prohibition applies **[**122]** to trustees in bankruptcy cases.⁷⁹ Third, the debtor's intent to continue his marijuana business post-petition constituted being "engaged in business" for purposes of [11 U.S.C. § 1304](#), requiring court approval for expenditure of funds pursuant **[**19]** to [11 U.S.C. § 363\(c\)](#).⁸⁰ The court could not approve any expenditures related to a marijuana business.⁸¹ Nonetheless, the court declined to dismiss the case and gave the debtor a shot at a discharge, but enjoined him from conducting his marijuana business or using any property of the estate in furtherance of illegal activity.⁸² The court further ordered the trustee to abandon all marijuana plants within the estate and ordered the debtor to destroy all his marijuana plants and byproducts as a condition remaining in bankruptcy.⁸³

In *In re ARM Ventures, LLC*,⁸⁴ debtor proposed a plan which would be funded through income generated by the sale of marijuana products. The court held a plan cannot be confirmed unless the business generating the income is legal under both state law and federal law.⁸⁵

⁶⁶ *Id.*

⁶⁷ [528 B.R. 178 \(Bankr. D. Ariz. 2015\)](#).

⁶⁸ [Id. at 181-82](#).

⁶⁹ [Id. at 188](#).

⁷⁰ [Id. at 185](#).

⁷¹ *Id.*

⁷² [Id. at 186-87](#).

⁷³ [Id. at 187-88](#).

⁷⁴ [532 B.R. 53 \(Bankr. W.D. Mich. 2015\)](#).

⁷⁵ [Id. at 55](#).

⁷⁶ [Id. at 56](#).

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ [Id. at 57](#).

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² [Id. at 59](#).

⁸³ *Id.*

⁸⁴ [564 B.R. 77 \(S.D. Fla. 2017\)](#).

⁸⁵ [Id. at 85](#).

That is, a reorganization plan dependent on marijuana income can *per se* be proposed in bad faith.⁸⁶ Indeed, debtor's tenant was not licensed by the state of Florida to grow marijuana, and was very unlikely to get a federal license.⁸⁷ Therefore, the court concluded debtor's plan was not feasible and the bankruptcy case was ripe for dismissal.⁸⁸ However, given the significant non-insider unsecured debt, the court declined **[**20]** to dismiss.⁸⁹ Instead, based on the debtor's bad faith arising from his illegal activities, the court granted stay relief to the debtor's major secured creditor.⁹⁰ However, the court stayed any foreclosure sale for 14 days to provide debtor an opportunity to file a plan that would not depend on the sale of marijuana as a source of income.⁹¹

In *NW, SPNWY, LLC v. Cook Investments NW*,⁹² debtor leased commercial property to a marijuana grower. As part of its plan, debtor proposed to reject the marijuana grower's lease. Because debtor's plan did not depend on future income derived from illegal activity, the court concluded the debtor's plan was confirmable.⁹³ On appeal and upon an objector's motion for stay pending appeal, the U.S. District Court for the Western District of Washington began with the simple observation "[b]ankruptcy courts are neither regulatory nor criminal courts."⁹⁴ The court continued "[a] rudimentary search of relevant authorities reveals that numerous courts have confirmed plans regardless of whether actual provisions of the plans result in the violation of federal or state laws."⁹⁵ Because the plan itself would not violate **[*123]** federal law, but instead would be funded

through **[**21]** proceeds of purely legal activity (because debtor rejected the marijuana lease), the district court denied the motion for stay pending appeal.⁹⁶

Finally, in *Olson v. Van Meter*,⁹⁷ the debtor filed Chapter 13 to prevent foreclosure on commercial property leased to the operator of a marijuana dispensary.⁹⁸ Debtor's plan called for sale of this real property to pay off creditors, and as a result required rejection of the lease with the marijuana dispensary.⁹⁹ Nonetheless, the court dismissed the case *sua sponte* on grounds the debtor's post-petition acceptance of rents from the dispensary business was ongoing criminal violation precluding federal bankruptcy relief.¹⁰⁰

The Bankruptcy Appellate Panel for the Ninth Circuit reversed and remanded.¹⁰¹ First, the appellate panel held the bankruptcy court did not sufficiently articulate the legal basis for its ruling or make findings to support its conclusion the debtor was violating federal law.¹⁰² The appellate panel held the court could not summarily dismiss the bankruptcy case, but rather was required to take evidence and make findings on issues of bad faith and unclean hands, as well as whether the debtor was actually committing a controlled substances act **[**22]** violation.¹⁰³ The appellate panel reasoned "[a]lthough debtors connected to marijuana distribution cannot expect to violate federal law in their bankruptcy case, the presence of marijuana near the case should not cause mandatory dismissal."¹⁰⁴

B. DEBTORS' POTENTIAL VIOLATIONS OF THE

⁸⁶ [Id. at 86.](#)

⁸⁷ [Id. at 84.](#)

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ [Id. at 86-87.](#)

⁹¹ *Id.*

⁹² [No. 17-5516, 2017 U.S. Dist. LEXIS 136129, 2017 WL 3641914 \(W.D. Wash. August 24, 2017\).](#)

⁹³ [Id. at *1.](#)

⁹⁴ [Id. at *2.](#)

⁹⁵ *Id.*

⁹⁶ [Id. at *6.](#)

⁹⁷ [No. NV-17-1168-LTiF, 2018 Bankr. LEXIS 480, 2018 WL 989263 \(9th Cir. BAP Feb. 5, 2018\).](#)

⁹⁸ [Id. at *1.](#)

⁹⁹ [Id. at *3.](#)

¹⁰⁰ [Id. at *6.](#)

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ [Id. at *7.](#)

¹⁰⁴ *Id.*

CSA*1. Complicity - Aiding and Abetting and Conspiracy*

Based on these authorities, this Court's first inquiry must be whether the Debtors are engaged in ongoing violations of federal law. If the analysis is answered in the affirmative, Debtors' bankruptcy cases may not proceed and would be ripe for dismissal.

There is no evidence before the Court that the Debtors directly "manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance[.]"¹⁰⁵ Therefore, if the Debtors are violating [§ 841\(a\)\(1\)](#), they are doing so indirectly, through one or more theories of legal complicity.

The first such allegation of Debtors' indirect criminal activity is Inniss's assertion Debtors' sale of hydroponic equipment to marijuana grow operations constitutes aiding and abetting CSA violations by its customers. Under federal law, aiding and abetting criminal activity is itself criminalized **[**23]** pursuant to [18 U.S.C. § 2](#), which provides "[w]hoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal." This is not to say aiding and abetting is an independent crime. Rather, [18 U.S.C. § 2](#) "simply abolishes the common-law distinction **[*124]** between principal and accessory."¹⁰⁶

"[U]nder [§ 2](#), those who provide knowing aid to persons committing federal crimes, with the intent to facilitate the crime, are themselves committing a crime."¹⁰⁷ "[A] person is liable under [§ 2](#) for aiding and abetting a crime if (and only if) he (1) takes an affirmative act in furtherance of that offense, (2) with the intent of facilitating the offense's commission," i.e., "with full knowledge of the circumstances constituting the charged offense."¹⁰⁸ "Mere presence at a crime scene

or knowledge alone that a crime is being committed is insufficient."¹⁰⁹ "[A] defendant must share in the intent to commit the underlying offense."¹¹⁰

Concomitant with his assertion the Debtors are aiding and abetting CSA violations, Inniss invokes conspiracy as an alternate theory of complicit liability pursuant to [§ 846](#). In the Tenth Circuit, to obtain a conviction for conspiracy **[**24]** in violation of [§ 846](#), the government must establish beyond a reasonable doubt: 1) there was an agreement to violate the law; 2) the defendant knew the essential objectives of the conspiracy; 3) the defendant knowingly and voluntarily took part in the conspiracy; and 4) the co-conspirators were interdependent.¹¹¹ "[T]he evidence that supports a conviction for conspiracy can also be used to support a conviction for aiding and abetting in the possession of illegal narcotics with intent to distribute."¹¹² The main difference between conspiracy and aiding and abetting is unlike co-conspirator liability, in that "liability as an aider and abetter is not contingent upon a prior 'agreement or conspiracy to perform' a criminal act."¹¹³

"A conviction for aiding and abetting can rest on a wide range of underlying conduct, including 'acts, words or gestures encouraging the commission of the offense,' either before or at the time of the offense."¹¹⁴ "Some

[71, 75-77](#); see also [Nye & Nissen v. United States, 336 U.S. 613, 619, 69 S. Ct. 766, 93 L. Ed. 919 \(1949\)](#) ("[T]o aid and abet another to commit a crime it is necessary that a defendant in some sort associate himself with the venture, that he participate in it as in something that he wishes to bring about, that he seek by his action to make it succeed." (quotation marks omitted)); [United States v. Rosalez, 711 F.3d 1194, 1205 \(10th Cir. 2013\)](#) (for an aiding and abetting conviction, the government must prove the defendant "shared in the intent to commit the underlying offense, willfully associated with the criminal venture, and aided the venture through affirmative action" (quotation marks omitted)).

¹⁰⁹ [Rosalez, 711 F.3d at 1205](#).

¹¹⁰ *Id.*

¹¹¹ [United States v. Isaac-Sigala, 448 F.3d 1206, 1210 \(10th Cir. 2006\)](#).

¹¹² [United States v. Carter, 130 F.3d 1432, 1441 \(10th Cir. 1997\)](#) (internal citation and quotation omitted).

¹¹³ [U.S. v. Bowen, 527 F.3d 1065, 1078 \(10th Cir. 2008\)](#) (quoting [U.S. v. Pursley, 474 F.3d 757, 759 \(10th Cir. 2007\)](#)).

¹¹⁴ [Williams v. Trammell, 782 F.3d 1184, 1192 \(10th Cir.](#)

¹⁰⁵ [21 U.S.C. § 841\(a\)\(1\)](#).

¹⁰⁶ [United States v. Cooper, 375 F.3d 1041, 1049 \(10th Cir. 2004\)](#).

¹⁰⁷ [United States v. Deiter, 890 F.3d 1203, 1214 \(10th Cir. 2018\)](#) (quoting [Rosemond v. United States, 572 U.S. 65, 134 S. Ct. 1240, 188 L. Ed. 2d 248 \(2014\)](#)).

¹⁰⁸ [Deiter, 890 F.3d at 1203](#) (quoting [Rosemond, 572 U.S. at](#)

mental state beyond 'mere assent' or 'acquiescence' is also required."¹¹⁵ "Even mere 'words or gestures of encouragement' constitute affirmative acts capable of rendering one liable **[*125]** under this theory."¹¹⁶ Because of this, the Tenth Circuit has held "a defendant may **[**25]** not stumble into aiding and abetting liability by inadvertently helping another in a criminal scheme unknown to the defendant."¹¹⁷

Of course, there are limitations to both theories of complicit liability. Importantly, Byrd testified Debtors are not "in" the marijuana industry but are instead "riding the wave." Debtors' position is they are not participating in violations of the CSA, but rather, merely providing general information to their customers which is useful and applicable to growing almost any type of crop, not just marijuana. There is case law supporting Debtors' theory providing information to customers does not violate the CSA.

In *Mann v. Gulickson*,¹¹⁸ a dispute arose over a contract for hydroponic and licensing consulting to the marijuana industry. The business was to "provide consulting and information services to persons desiring to engage in hydroponic farming" and to "provide consulting and documentation preparation services to persons or entities desiring to establish medical cannabis dispensaries and related businesses in states where such activities were legal."¹¹⁹ At no time did these companies possess, cultivate or distribute cannabis plants.¹²⁰ Instead, its income was derived **[**26]** solely from the sale of consulting services and information packs and document preparation.¹²¹

The question before the court in *Gulickson* was whether a contract for these services was enforceable

notwithstanding the CSA.¹²² The court held the contract could be enforced because of California's liberal policy of the "legality" element of contracts.¹²³ In a footnote the court observed:

[The] object of the contract here is not *necessarily* illegal. The parties agreed Gullickson would pay Mann to purchase the Companies. . . . There is no evidence in the record that the Companies actually possess, use, cultivate, or distribute marijuana—medical or otherwise.

Moreover, while Gullickson argues the businesses "conspire" to do so, this so-called conspiracy appears to be based entirely on providing information to customers. In *Conant v. Walters*, the Ninth Circuit affirmed an injunction prohibiting federal officials from revoking a physician's registration, or even investigating a physician's conduct, based on the physician's recommendation that a patient use marijuana.¹²⁴

In *Green Earth Wellness Center, LLC v. Atain Specialty Insurance Co.*,¹²⁵ the U.S. District Court for the District of Colorado addressed another **[**27]** breach of contract claim against this backdrop. Green Earth operated a medical marijuana business, for which Atain provided commercial liability insurance.¹²⁶ Green Earth made two claims **[*126]** under its policy, both of which Atain denied.¹²⁷ The first claim was for damage to Green Earth's marijuana plants because of a wildfire; the second was for the theft of some of its marijuana plants.¹²⁸

Green Earth sued Atain for breach of contract, among

[2015](#)).

¹¹⁵ [Id. at 1193](#) (quoting [Wingfield v. Massie](#), [122 F.3d 1329, 1332 \(10th Cir. 1997\)](#)).

¹¹⁶ [Id.](#)

¹¹⁷ [U.S. v. Rufai](#), [732 F.3d 1175, 1190 \(10th Cir. 2013\)](#).

¹¹⁸ [No. 15-CV-03630-MEJ](#), [2016 U.S. Dist. LEXIS 152125, 2016 WL 6473215, at *7 \(N.D. Cal. Nov. 2, 2016\)](#).

¹¹⁹ [Id. at *1](#).

¹²⁰ [Id. at *2](#).

¹²¹ [Id.](#)

¹²² [Id. at *3](#).

¹²³ [Id. at *4](#).

¹²⁴ [Id. at *7 n.4](#) (citing [Cnuant v. Walters](#), [309 F.3d 629, 639 \(9th Cir. 2002\)](#) (indicating rejection of government's argument that a doctor's "recommendation" of marijuana encourages illegal conduct by the patient)).

¹²⁵ [163 F. Supp. 3d 821, 823 \(D. Colo. 2016\)](#).

¹²⁶ [Id. at 823](#).

¹²⁷ [Id. at 823-24](#).

¹²⁸ [Id. at 824](#).

other things.¹²⁹ Atain moved for summary judgment, arguing public policy based on the federal prohibition on marijuana required denying coverage for Green Earth's losses.¹³⁰ The court noted that "the nominal federal prohibition against possession of marijuana conceals a nuanced (and perhaps even erratic) expression of federal policy."¹³¹ The *Green Earth* court explained that because of "a continued erosion of any clear and consistent federal public policy in this area. . . . the Court declines Atain's indirect invitation to declare the Policy void on public policy grounds."¹³² The court found that "Atain, having entered into the Policy of its own will, knowingly and intelligently, is obligated to comply with its terms or pay damages for having breached it."¹³³ The court consequently **[**28]** denied Atain's summary judgment motion.

Pursuant to these authorities, to determine whether Debtors are complicit through aiding and abetting their customers' violations or conspiring with them to do so, the Court must decide whether Debtors' conduct rises above the level of merely providing information to customers, and instead, evidences a specific intent for the Debtors to assist their customers in violating [§ 841\(a\)\(1\)](#). Additionally, to find conspiracy liability under [§ 846](#) the Court must further find an agreement between Debtors' and their customers to violate the law.

The Court concludes the Debtors are violating neither [§ 846](#) nor [18 U.S.C. § 2](#). As to conspiracy liability, there is insufficient evidence before the Court concerning an actual agreement between Debtors and their customers to violate the CSA. While, as discussed in further detail below, the Debtors may be aware at least some of their customers will use equipment purchased from the Debtors to manufacture a controlled substance (and this may give rise to a separate violation of the CSA), the Debtors' sales are never contingent or directly affected by the crop being grown. As in *Gullickson*, the contracts between Debtors and their customers, if any, **[**29]** do not specifically contemplate, depend upon, or require any activity that is necessarily illegal.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ [Id. at 832.](#)

¹³² [Id. at 834.](#)

¹³³ [Id. at 835.](#)

Likewise, the Court concludes the Debtors' business activities do not evidence a specific intent to violate the CSA. Under *Rosalez*, which this Court is bound to follow, aiding and abetting liability requires more than "knowledge alone that 'a crime is being committed[.]'"¹³⁴ Instead, the Court would need to conclude Debtors share the same intent as their customers to violate the CSA and willfully associate themselves with their customers' criminal ventures.¹³⁵ The Debtors' mens rea does not meet this exacting standard.

The Debtors' business is not limited in scope to marijuana sales. The evidence certainly shows many of the Debtors' customers **[*127]** are in the marijuana industry. As discussed below, this fact is no secret to the Debtors. However, by its nature and as shown by the evidence, the Debtors' business serves a broad customer base consisting of both commercial and individual horticulturalists, growing a variety of legal crops. Debtors' intent is to sell its product to any clientele engaged in hydroponic horticulture, and Debtors' products are generally applicable to those activities regardless **[**30]** the specific crop grown. Without sharing its marijuana-connected customers' specific intent to cultivate and distribute marijuana, Debtors are not aiding and abetting violations of the CSA.

2. Sale of Drug Manufacturing Equipment

While the Debtors are not violating the CSA through complicity in their marijuana growing customers' crimes, another provision of the CSA produces violations based upon a lesser mens rea of simply knowing how Debtors' products will be used. Specifically, [§ 843\(a\)\(7\)](#) makes it a federal crime to "manufacture" or "distribute" any "equipment, chemical, product or material which may be used to manufacture a controlled substance . . . knowing, intending, or having reasonable cause to believe, that it will be used to manufacture a controlled substance" ¹³⁶

In *U.S. v. Truong*,¹³⁷ the Tenth Circuit analyzed the

¹³⁴ [Rosalez, 711 F.3d at 1205.](#)

¹³⁵ *Id.*

¹³⁶ [21 U.S.C. § 843\(a\)\(7\).](#)

¹³⁷ [425 F.3d 1282 \(10th Cir. 2005\).](#) As discussed supra, the

"reasonable cause to believe" element of [§ 843\(a\)\(6\)](#), which makes it unlawful to possess any equipment, chemical or product which may be used to manufacture a controlled substance knowing, intending, or having reasonable cause, that it will be used to manufacture a controlled substance. [Sections 843\(a\)\(6\)](#) and [\(7\)](#) are nearly identical, with [sub-section \(a\)\(6\)](#) criminalizing possession of drug manufacturing **[**31]** equipment, and [sub-section \(a\)\(7\)](#) criminalizing manufacture, distribution or exportation of drug manufacturing equipment. While both seem applicable in this case because Debtors both possess and sell their hydroponic equipment, the Court will refer primarily to [sub-section \(a\)\(7\)](#) as it is the sale of equipment which concerns the Court. In any event, according to *Truong* and other cases cited below, the scienter requirement of each sub-section (and, separately, possession and distribution of chemical precursors charged under [§ 841\(c\)\(2\)](#)) are the same, so the distinction is practically without a difference.

In *Truong*, the defendant sold large quantities of pseudoephedrine, which can be used to manufacture methamphetamine.¹³⁸ Observing [§ 843\(a\)\(6\)](#) contains "an unusually specific mens rea requirement[.]" the Court of Appeals held "[i]t is not sufficient for the government to prove that the defendant knew, intended, or had reasonable cause to believe that the substance would be abused or would be used illegally. Nor is it sufficient for the government to prove that the defendant was negligent or reckless with respect to the risk The government must prove the defendant was aware, or had reasonable **[**32]** cause to believe, that the substance would be used for the specific purpose" of manufacturing drugs.¹³⁹

Thus, under the law of this Circuit the "reasonable cause to believe" **[*128]** standard employed by both [§§ 843\(a\)\(6\)](#) and [\(a\)\(7\)](#) is "akin to actual knowledge."¹⁴⁰ That is, the inquiry is "entirely subjective, the inquiry is not to be viewed from the perspective of a hypothetical

distinction between [sub-section \(a\)\(6\)](#) and [\(a\)\(7\)](#) has no substantive bearing on the Court's analysis, and therefore *Truong's* references to [sub-section \(a\)\(6\)](#) apply equally to the Court's analysis under [sub-section \(a\)\(7\)](#).

¹³⁸ [Id. at 1284](#).

¹³⁹ [Id. at 1289](#).

¹⁴⁰ *Id.* (citing [United States v. Saffo](#), 227 F.3d 1260, 1269 (10th Cir. 2000)).

reasonable person."¹⁴¹ In *Truong*, to convict, the jury was required to infer the defendant "had actual knowledge, or something close to it, that the pseudoephedrine and ephedrine he sold would be used to manufacture methamphetamine."¹⁴² "A defendant's own actions or words may . . . reveal his knowledge that he is selling" material which will be used to manufacture a controlled substance.¹⁴³

Ultimately, the Tenth Circuit held the government had not sufficiently proven actual knowledge the products sold would be used to manufacture drugs, reversing the defendant's conviction.¹⁴⁴ The only evidence the government presented to prove the defendant had actual knowledge pseudoephedrine could be used to manufacture methamphetamine was the defendant's statement he did not know how the pseudoephedrine he sold would be used.¹⁴⁵ There was no evidence the defendant **[**33]** had ever learned of any connection between pseudoephedrine and methamphetamine production, and no evidence any of defendant's statements indicated he knew the his pseudoephedrine would be used for such a purpose.¹⁴⁶ Even though there was evidence to permit the jury to infer defendant was "up to no good[.]" and even though the evidence showed a reasonable person would be on notice "something nefarious was going on[.]" the "unusually specific mens rea requirement of [21 U.S.C. §§ 841 and 843](#)" requires more.

Notably, *Truong* is considered as reflecting the minority view of the mens rea required to violate [§ 843\(a\)\(6\)](#) or [\(a\)\(7\)](#), and [§ 841\(c\)\(2\)](#).¹⁴⁷ At least three other circuits

¹⁴¹ [United States v. Buonocore](#), 416 F.3d 1124, 1133 (10th Cir. 2005).

¹⁴² [Truong](#), 425 F.3d at 1289.

¹⁴³ [Id. at 1290](#).

¹⁴⁴ [Id. at 1291](#).

¹⁴⁵ *Id.*

¹⁴⁶ *Id.*

¹⁴⁷ [Section 841\(c\)\(2\)](#) criminalizes knowingly or intentionally possessing or distributing "a listed chemical knowing, or having reasonable cause to believe, that the listed chemical will be used to manufacture a controlled substance" The "reasonable cause to believe" standard set forth in [§ 841\(c\)\(2\)](#) uses the exact same language as [§ 843\(a\)\(6\)](#) and [\(a\)\(7\)](#), and

have held these statutes allow conviction either upon subjective knowledge or an objective "cause to believe."¹⁴⁸ In *U.S. v. Williamson*, the Tenth Circuit Court of Appeals mildly distinguished *Truong*, without changing the court's interpretation of the "reasonable cause to believe" standard, by explaining *Truong* depended on the court's view "based on only the information known to the specific defendant, a reasonable person would not have had reason to believe that the pseudoephedrine [*129] would be used to make methamphetamine."¹⁴⁹

Even as the minority view, the **[**34]** Court is bound to follow *Truong* and apply its interpretation of the scienter requirement under [§ 843\(a\)\(6\)](#) and [841\(c\)\(2\)](#) to this Court's analysis under [§ 843\(a\)\(7\)](#). In this case, however, the rules delineating the "reasonable cause to believe" standard may have little effect, because the Court finds the Debtors indeed have actual knowledge they are selling equipment which will be used to manufacture a controlled substance.

As the Court reads [§ 843\(a\)\(7\)](#), the important distinction for purposes of criminality is not the specific product being sold, but whether the seller of such product knows how equipment will be used. There is little doubt hydroponic supplies are "equipment" related to marijuana cultivation. Indeed the Tenth Circuit has held evidence of the existence of a hydroponic grow operation supports a warrant for search and seizure on a charge of producing a controlled substance with intent to distribute.¹⁵⁰

There is ample evidence in this case proving Debtors

therefore the scienter requirement is the same.

¹⁴⁸ Cf. *Truong*, 425 F.3d 1282 with *U.S. v. Galvan*, 407 F.3d 954, 957 (8th Cir. 2005) (rejecting jury instruction that required actual knowledge for conviction under [Section 841\(c\)\(2\)](#)), *U.S. v. Kaur*, 382 F.3d 1155, 1157-58 (9th Cir. 2004) (holding the "reasonable cause to believe" standard of [Section 841\(c\)\(2\)](#) incorporates both subjective and objective considerations), and *U.S. v. Prather*, 205 F.3d 1265, 1270 (11th Cir. 2000) ("[T]he jury thus needed to find either that he knew the pseudoephedrine would be used to manufacture methamphetamine or that he had reasonable cause to believe that it would be."). See also *U.S. v. Khattab*, 536 F.3d 765, 769 (7th Cir. 2008) (discussing circuit split).

¹⁴⁹ [746 F.3d 987, 994 n.2 \(10th Cir. 2014\)](#).

¹⁵⁰ *U.S. v. Montgomery*, 262 Fed. Appx. 80, 84 (10th Cir. 2008) (unpublished).

have "reasonable cause to believe" the equipment they sell to at least some of their customers will be used to manufacture marijuana. First, Inniss testified meeting the needs of cannabis growers is essential to Debtors' business, because those growers will simply **[**35]** buy their hydroponic equipment elsewhere if Debtors cannot meet their needs. Inniss also testified Debtors' business increased significantly and immediately upon the federal government issuing the Cole Memo.¹⁵¹ Inniss testified negotiations for the sale of the business to Byrd were "very specific in terms of cannabis." Inniss referred to Byrd as "Mr. Marijuana Entrepreneur" and testified the "whole thesis" of the transaction was to combine Byrd's California marijuana-related operations with the Debtors' operations in Colorado. Inniss testified the Debtors have always chosen products based on their favorability of use in marijuana cultivation, including by customizing Debtors' pesticide inventory to provide products approved for use in marijuana cultivation by the Colorado Department of Agriculture. Debtors even sell some products that Inniss testified would be cost-prohibitive for use in cultivating any crop except marijuana, because marijuana is the highest yielding cash crop which can be grown. Even further, Inniss testified Debtors sell so-called "bubble bags" which are specifically used to make "water hash," a concentrated marijuana derivative.

The Court finds Inniss's testimony credible. **[**36]** Despite the acrimony in the parties' relationship, Inniss based his testimony on personal experience both as the founder and principal operator of the Debtors' business for many years before the sale to Byrd. Inniss's testimony confirms the Debtors' business model and operations have not materially changed since the sale to Byrd, and as a result Inniss's testimony regarding the business of what were once his companies is both credible and based upon first-hand, personal knowledge.

Many of Debtors' largest customers use aliases with Debtors rather than the real name of their business.¹⁵² While the Court can **[*130]** simply infer the use of aliases knowingly disguises some nefarious activity, Inniss gave un rebutted testimony linking the aliases on Debtors' customer lists to specifically identified dispensaries and

¹⁵¹ The enforcement of federal marijuana laws in the District of Colorado has not materially changed since the Cole Memo was revoked by Attorney General Jeffrey Sessions in early 2018.

¹⁵² Exh. 8, p. 19.

grow operations, all of which Inniss said he has disclosed to Byrd.

Debtors have participated, in some fashion, in the "Cannabis Cup" since at least 2016. The Cannabis Cup is a cannabis industry trade show and the world's biggest marijuana grow competition. Other "grow offs" attended by Debtors include the Indo Expo, The Grow Off, and Max Yields. At these and similar events, Debtors have given **[**37]** away promotional materials bearing the Way to Grow name in the form of lighters and rolling papers, which, together, are strongly associated with marijuana use.¹⁵³ Debtors have booths at the events and use them to build closer relationships to marijuana dispensaries and growers. Debtors have contributed prize money to be awarded to the winners of the grow-offs. Debtors do "cross-promotions" with dispensaries and advertise deals on a cannabis talk show.

Bradley Hale, who has been the store manager for the Debtors' Boulder location since May 2011, testified he, and all of his co-workers, were themselves marijuana growers who bought supplies from the Debtors before becoming employees. Most of Hale's interactions with customers have been about cannabis. Hale described Way to Grow stores as having a "Cheers Bar" atmosphere, where everyone knows your name and forming personal relationships is key to sales. Hale confirmed Debtors choose products based on favorability of use in marijuana cultivation. Hale also confirmed the "trim bags" and "bubble bags" sold by Debtors are specifically intended for use with cannabis. As recently as August 2018, Hale testified Debtors engaged in cross-promotions **[**38]** with dispensaries at local grow-offs. Hale testified as much as 95% of customers in his store are using Debtors' products to grow marijuana.¹⁵⁴

Cody Ross, manager of Debtors' Fort Collins location for the past five years, and with experience in other of the Debtors' stores, testified "everybody just assumes" customers talking generally about help with plants are talking about marijuana plants. Ross testified Debtors have a reputation for being experts in "advising on cannabis growing and . . . in selling products that are geared toward cannabis[.]" Ross has even visited cannabis growing facilities which are also Debtors' customers. A list of approved products for use in

cannabis cultivation is made available in the store; Debtors do not have that for any other plants. Customers sometimes bring marijuana plants, or, more commonly, photographs of marijuana grow operations, to Debtors' stores, and Debtors' employees "typically" offer products to those customers based on those photographs. If there was any doubt remaining from his testimony, Ross expressly stated, "I know what a lot of them grow" and then, when asked if they grow cannabis, responded "Yes, sir" as to the "vast majority" of **[**39]** those customers.

Next, the Court reviewed press statements and so-called "investor decks" prepared by an investment banking firm on behalf of the Debtors. These show Byrd has commented to Bloomberg Markets, "[w]e are the picks and shovels play for what we're calling the Green Rush."¹⁵⁵ In a statement to Business Wire, Byrd stated, **[*131]** "[w]ith the merger of Way to Grow completed in January 2016, Pure Agro is now the leading one-stop solution for indoor plant, product and cannabis growers in Colorado and California."¹⁵⁶ In March 2016, Byrd commented to the BusinessDen publication that Debtors' new location would "cater to commercial cannabis growers instead of private hobbyists growing at home."¹⁵⁷

An investor deck prepared on behalf of the Debtors by an investment banking firm specifically refers to marijuana as "the catalyst for hydroponic R&D."¹⁵⁸ The investor decks said the company would "take advantage of the current growth of the marijuana industry" and will "leverage the marijuana industries profitability[.]"¹⁵⁹ A second investor deck gave statistics on marijuana legalization and growth trends.¹⁶⁰ Yet another, dated January 2018, identifies, by name (and logo), five marijuana dispensaries as Debtors' **[**40]** "Notable Customers."¹⁶¹

¹⁵⁵ Exh. 11, p. 1.

¹⁵⁶ *Id.* p. 2.

¹⁵⁷ Exh. 18; see also Exh. 19 (press release touting advances in marijuana legalization as relating to hydroponics supply industry).

¹⁵⁸ Exh. 24.

¹⁵⁹ *Id.* p. 12.

¹⁶⁰ Exh. 25 pp. 20-21.

¹⁶¹ Exh. 59, p. 20.

¹⁵³ Exhs. 40 and 41.

¹⁵⁴ Byrd later disputed this figure as being closer to 65%.

Finally, the Court reviewed a very-telling e-mail drafted by Joe Pyle, Debtors' VP of Operations, to all of Debtors' store managers.¹⁶² In the e-mail, dated June 28, 2018, Pyle instructed the managers to "remove from sight" anything "MJ related in your stores" such as "tv screens with MJ related content, the 3 a light book, pictures, posters, anything."¹⁶³ Pyle further instructed the managers to "not discuss MJ directly with any customers and do not allow customers to bring anything plant related into your stores."¹⁶⁴ While, on the one hand, the e-mail evidences what may be post-petition remedial measures, it clearly demonstrates Debtors' prior use of marijuana related signage in their stores, as well as consciousness of the negative effects continued use of marijuana signage may have on Debtors' ability to remain in bankruptcy.

Considering this abundant evidence, Debtors' efforts to distance themselves from knowledge of their customers' use of their products is simply not credible. Even though the Court concludes Debtors do not share their customers' specific intent to violate the CSA, Debtors certainly know they are selling products to customers who will, and do, **[**41]** use those products to manufacture a controlled substance in violation of the CSA. Debtors tailor their business to cater to those needs, tout their expertise in doing so, and market themselves consistent with their knowledge. There is no evidence this business model has materially changed post-petition.

The Court concludes Debtors' business model and execution thereof fundamentally violates [§ 843\(a\)\(7\)](#). These violations continue post-petition, placing this case squarely within the rule adopted by Judge Tallman in *Rent-Rite Super Kegs*. To use Judge Tallman's words, even if the Debtors "are never charged or prosecuted under the CSA, [they] are conducting operations in the normal course of [their] business that violate federal criminal law."¹⁶⁵ This Court cannot enforce federal **[*132]** law in aid of the Debtors because Debtors' ordinary course activities constitute a continuing federal crime. The Court finds this is, inescapably, cause to dismiss this bankruptcy case under [11 U.S.C. § 1112\(b\)](#).

¹⁶² Exh. 52.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ [Rent-Rite, 484 B.R. at 805](#).

Having reached this conclusion, the Court nevertheless considered whether any alternative to outright dismissal, or other post-petition changes to Debtors' business, could cure the ongoing violations of federal law in this case. However, **[**42]** unlike *In re Johnson*¹⁶⁶ and *In re ARM Ventures, LLC*,¹⁶⁷ the evidence demonstrates extreme improbability the Debtors could survive if they were to sever all ties to their marijuana customers. Debtors' business activities constituting violations of the CSA are a major part of Debtors' ordinary course of business. Whether marijuana-related customers account for 65% or 95% of Debtors' revenue, eliminating all such revenue would be devastating to the Debtors. It is inconceivable Debtors could terminate any sales to known marijuana cultivators and still operate profitably.

In any event, the Court does not believe such an order, or the remediation it would require, would be effective in this case. The Court cannot simply order Debtors to cease all sales to customers known to be involved in marijuana cultivation, because the usefulness of Debtors' products in illegal grow operations will continue to attract marijuana horticulturalists to Debtors' business, including those growing marijuana solely for personal use. Debtors have already acquired a venerable reputation for expertise in hydroponic marijuana growing, and it is difficult to imagine how Debtors could prevent customers from continuing to **[**43]** patronize Debtors' stores because of this reputation. Indeed, the evidence does not show Debtors' essential business model has changed post-petition, which, of course, is the relevant time to determine whether Debtors may remain in bankruptcy. In any event, any such order would require the Court, and interested parties, to monitor the Debtors' sales and customers, which would be very difficult and inefficient. Further, in light of the acrimonious nature of Inniss's relationship with the Debtors, the Court can be reasonably certain such an order would lead to costly and time-consuming future litigation over the Debtors' compliance.

To prevent this Court from violating its oath to uphold federal law, under the specific facts of this case, the Court sees no practical alternative to dismissal.

C. Other Arguments for Dismissal

¹⁶⁶ [532 B.R. at 53](#).

¹⁶⁷ [564 B.R. at 77](#).

Inniss raises several further issues allegedly supporting dismissal or abstention. These include Debtors' alleged violations of the Court's cash collateral orders and the two-party nature of the dispute between Debtors and Inniss. Having found cause to dismiss upon the Debtors' continuing violations of the CSA, the Court need not address the remainder of these issues. **[**44]** The Court notes, however, it found the testimony of Debtors' financial advisor, John Thomspson, to be very credible, and the Court likely would have concluded based on Thompson's testimony the Debtors are not violating the Court's cash collateral orders. The Court also notes, having taken judicial notice of the claims registers in this case, this bankruptcy is far from a two-party dispute.

orders for joint administration of Debtors' cases are TERMINATED, the Motion to Dismiss is GRANTED, and Debtors' cases are DISMISSED. All pending motions are DENIED as moot and any scheduled hearings are VACATED.

Dated December 14, 2018.

BY THE COURT:

/s/ Michael E. Romero

Michael E. Romero, Chief Judge

United States Bankruptcy Court

CONCLUSION

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A bankruptcy court, as a court of limited and equitable jurisdiction, very rarely finds itself analyzing potential violations of **[*133]** federal criminal law. In this case, such analysis is unavoidable due to the divergence between the non-enforcement of federal marijuana laws. This Court is bound to follow the law as written and may not depart therefrom based on enforcement decisions made by the executive branch.

The result in this case may be viewed by many as inequitable. The Debtors are insolvent, and their business could benefit significantly from reorganization under the Bankruptcy Code. The Debtors likely did not seek bankruptcy relief in bad faith on a subjective standard. But for the marijuana issue, this would be a relatively run-of-the-mill Chapter 11 proceeding. As stated, even following **[**45]** those courts which have crafted alternatives to dismissal when debtors were violating the CSA would produce no practical or efficient alternative to dismissal in this case. At bottom, if the result in this case is unjust, Congress alone has power to legislate a solution.

Ironically, if Inniss, as the party arguing Debtors are violating federal law, wrests control of the Debtors back from Byrd in the State Case, he will almost certainly continue, and perhaps expand, the Debtors' ongoing marijuana-related operations. This irony is not lost on the Court but provides no legal basis for an alternate outcome. The Court casts no aspersions upon the Debtors or their businesses. The result in this case is dictated by federal law, which this Court is bound to enforce.

Accordingly, it is ORDERED the, Court's previous

Chapter Ten
Section 3

Stub Rents

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STUB RENT

Section 365(d)(3) of the Bankruptcy Code governs the obligation of a debtor or trustee, as tenant, to pay its landlord rent during the period beginning with the filing of a bankruptcy case and ending on the date the debtor or trustee assumes or rejects its interest in such lease for non-residential real property. Although section 365(d)(3) appears unambiguous on its face, it has been inconsistently interpreted by the courts. One issue that has divided courts is the payment of “stub rent” for the period between the petition date and the date that the first post-petition rent payment is due.¹ Should section 365(d)(3) require the payment of such rent? As discussed below, the two prevailing approaches are the billing date (or performance date) and the accrual (or proration) approaches. Under the latter approach, a landlord is paid stub rent, while under the former, it is not.

I. Background

Section 365(d)(3) was enacted in 1984 as part of the “Shopping Center Amendments.” Prior to the 1984 amendments, section 365 provided that if a lease was assumed, the estate would be liable for the rent fixed in the lease; but if the lease was rejected, the estate would be liable only for an administrative expense under section 503 for the period of actual use and only to the extent of the actual benefit received by the estate. This created several problems for commercial lessors, including, as described by Senator Orrin Hatch, a key sponsor of the 1984 amendments:

[D]uring the time the debtor has vacated space but has not yet decided whether to assume or reject the lease, the trustee [may have] stopped making payments under the lease. In this situation, the landlord is forced to provide current services—the use of its property, utilities, security, and other services—without current payment.

Thus, the amendments lessened this problem by requiring timely performance of all of the debtor’s obligations under a lease of nonresidential real property during the post-petition/pre-rejection or assumption period, regardless of whether the property is used by the bankruptcy estate.

II. The Billing Date Approach

The billing date approach provides that “an obligation arises under a lease for the purposes of § 365(d)(3) when the legally enforceable duty to perform arises under that lease.” *Centerpoint Props. v. Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)*, 268 F.3d 205, 211 (3d Cir. 2001).² Under this approach, if rent is due, e.g.,

¹ While substantially the same issues affect rent for the period between the date a lease is rejected and the end of the billing-period in which such lease is rejected, these materials primarily discuss stub rent as described above.

² See also, e.g., *Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986, 989 (6th Cir. 2000); *Burival v. Roehrich (In re Burival)*, 613 F.3d 810, 813 (8th Cir. 2010); *HA-LO Indus., Inc. v. CenterPoint Props. Tr.*, 342 F.3d 794, 800 (7th Cir. 2003); *In re Oreck Corp.*, 506 B.R. 500, 506 (Bankr. M.D. Tenn.

on September 1 and the debtor-lessee files a bankruptcy case, *e.g.*, on September 15, then none of the rent for September is considered a post-petition obligation subject to section 365(d)(3). Courts that adopt this approach primarily rely on the plain language of the statute, which such courts consider to be unambiguous. These courts “acknowledge that the result [they] reach may in some cases leave room for strategic behavior on the part of landlords and tenants,” but conclude that “strategic behavior . . . can be constrained by forethought and careful drafting.” *Id.* at 212.

III. The Accrual Approach

The accrual approach allocates rent on a *per diem* basis for each day of the affected period. With respect to monthly rent billed in advance on September 1, if the debtor-lessee files a bankruptcy case on September 15, then “stub rent” would be payable under section 365(d)(3) from the petition date to the end of the monthly rental period.³ Arguments for the accrual approach include that:

- (i) proration is simple to apply; (ii) the method produces equitable results as it allows both landlords and tenants to get what they bargained for . . . ; (iii) proration is consistent with the long-standing, pre-amendment practice of prorating lease obligations pending rejection; (iv) neither the statute nor its legislative history indicates proration is precluded; and (v) proration is consistent with other provisions of the Bankruptcy Code, such as §§ 365(g) and 502(g).

Stone Barn Manhattan, 398 B.R. at 364. Generally, the accrual approach is favorable to landlords in two situations: “[1] when the lease calls for rent to be paid in advance on a date preceding the order for relief; and [2] when the lease calls for rent to be paid in arrears on a date after the rejection of the lease.” *NETtel*, 289 B.R. at 493. In each situation, such rent would not be payable under section 365(d)(3) pursuant to the billing date approach.

IV. Additional Considerations

The arguments for and against each approach depend heavily on the factual circumstances of the case. For example, a court might apply the billing date approach to a lease obligation for monthly, base rent billed in advance during the post-petition/pre-rejection period but covering a period of time after the debtor’s rejection of the lease takes effect (*e.g.*, the Seventh Circuit’s decision in *HA-LO Industries*) and

2014); *In re Imperial Beverage Grp., LLC*, 457 B.R. 490, 501 (Bankr. N.D. Tex. 2011); *In re F & M Distributions, Inc.*, 197 B.R. 829, 832 (Bankr. E.D. Mich. 1995).

³ See, *e.g.*, *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125, 1128 (7th Cir. 1998); *El Paso Props. Corp. v. Gonzales (In re Furr’s Supermarkets, Inc.)*, 283 B.R. 60, 68 (B.A.P. 10th Cir. 2002); *In re Leather Factory Inc.*, 475 B.R. 710, 714 (Bankr. C.D. Cal. 2012); *In re Circuit City Stores, Inc.*, 447 B.R. 475, 510 (Bankr. E.D. Va. 2009); *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 365 (Bankr. S.D.N.Y. 2008); *Heathcon Holdings, LLC v. Dunn Indus., LLC (In re Dunn Indus., LLC)*, 320 B.R. 86, 93 (Bankr. D. Md. 2005); *In re NETtel Corp., Inc.*, 289 B.R. 486, 489–97 (Bankr. D.D.C. 2002); *In re Travel 2000, Inc.*, 264 B.R. 444, 451 (Bankr. W.D. Mich. 2001); *In re All for A Dollar, Inc.*, 174 B.R. 358, 362 (Bankr. D. Mass. 1994).

apply the accrual approach to a lease obligation for a biannual installment of real estate taxes billed in arrears during the post-petition/pre-rejection period and passed through to the lessee but covering a period of time before the petition date (e.g., the Seventh Circuit's decision in *Handy Andy*). The issue becomes even murkier when applied to other lease obligations, such as percentage rent for sales above a breakpoint where the breakpoint was reached post-petition in part because of the debtor-tenant's pre-petition sales. See, e.g., *Equitable Life Assurance Soc'y of the U.S. v. Petrie Retail, Inc. (In re Petrie Retail, Inc.)*, 233 B.R. 256, 260–61 (S.D.N.Y. 1999). Accordingly, attorneys should consider all relevant facts when dealing with stub rent issues.

Chapter Ten
Section 4

Lease Terminations as Fraudulent Transfers: Reconciling Bankruptcy Code Sections 548 and 365(C)(3)

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Lease Terminations as Fraudulent Transfers: Reconciling Bankruptcy Code Sections 548 and 365(C)(3)

Under section 365(c)(3) of the Bankruptcy Code, the bankruptcy trustee (and equivalents) may not assume or assign a nonresidential lease that was terminated before the tenant-debtor's bankruptcy. Before bankruptcy, the tenant-debtor may terminate a valuable lease and enrich the landlord as a result. May the bankruptcy trustee claim that the termination is a fraudulent transfer under section 548, even though the trustee may not assume or assign the lease?

My answer of course is: why not!

The Seventh Circuit answered this very question in *In re Great Lakes Quick Lube LP (Great Lakes)*. *Great Lakes II*, 816 F.3d 482 (7th Cir. 2016). There, in a decision delivered by Judge Richard Posner, the Seventh Circuit ruled that a nonresidential lease termination could be a fraudulent transfer from the tenant-debtor to the landlord. In Judge Posner's view, section 365(c)(3) did not apply to the terminations at issue. The creditors' committee sued the landlord under section 548 not to assume the leases themselves, but to recover their value, an option made available in section 550(a). Recovering the value of the leases from the landlord would not disturb the occupancy of the properties' new tenant. Thus, the distinction between the value of the leases and the leases themselves enabled the creditors' committee to pursue its fraudulent transfer claim without defeating section 365(c)(3)'s purpose.

Before discussing the applicability of section 365(c)(3) (or rather, its inapplicability), Judge Posner answered the antecedent question of whether the lease terminations were "transfers" under the Bankruptcy Code; and, therefore, for section 548's purposes. He decided they were, relying solely on the text of section 101(54)(D), which defines "transfer." The tenant-debtor and the landlord agreed to terminate their lease agreements, and as a result the tenant-debtor parted with property interests that might have been worth something to the creditors had the terminations not taken place. For this simple reason, the terminations were transfers.

Judge Posner's opinion was correct -- even though the opinion cites no case law, its arguments are supported by several authorities. But at the same time, *Great Lakes* appears to contradict other cases that say—whether because of section 365(c)(3) or independently of it—that nonresidential lease terminations do not satisfy the Bankruptcy Code's definition of "transfer."

The case law's apparent inconsistencies are mostly just that—apparent, not actual. But even the appearance of inconsistency is regrettable because it reflects the failure of courts to develop an adequate theory for applying fraudulent transfer law to lease terminations. As long as this area remains under-theorized, courts may struggle to apply sections 548 and 365(c)(3) consistently.

Sharks, I make two main arguments.

First, a lease termination is a transfer under the Bankruptcy Code, provided the tenant-debtor had control of the lease at the time of its termination. By “control,” I mean simply the right of the tenant-debtor to choose between terminating the lease and not terminating it. Take the Great Lakes tenant-debtor, for example. It agreed to terminate its leases but had the absolute right not to enter that agreement. The tenant-debtor thus exercised the requisite control, making the terminations transfers,

Second, I argue that the scope of section 365(c)(3) is ill-defined for two main reasons. First, courts have, for the most part, dealt clumsily with the interaction of sections 548 and 365(c)(3), applying them where they should not have and failing to apply them (or even discuss them) where they should have. Judge Posner’s Great Lakes opinion is a step toward greater sophistication in this area, but it leaves some room for development. Second, the text of section 365(c)(3) is overinclusive, meaning it brings into the statute’s ambit cases that its background justification does not cover. Specifically, section 365(c)(3), as written, prohibits the trustee from recovering nonresidential leases even where the landlord has not re-leased or sold the property. This prohibition not only fails to serve section 365(c)(3)’s purpose—it threatens to defeat it.

Some Notes:

- Lease Terminations as Fraudulent Transfers and the Scope of Section 365(c)(3)

Section 365(A) And Lease Valuations

The bankruptcy estate includes the debtor’s rights and interests in real property, including rights and interests existing under leases. Section 365(a) authorizes the trustee to assume and assign (or reject) unexpired leases of the debtor. 11 U.S.C. § 365(a) But an unexpired lease may be assumed only after certain defaults have been cured and future performance assured.

The trustee will only assume an unexpired lease if, after curing its defaults, it is valuable enough to benefit the unsecured creditors. Otherwise, the trustee will reject it.

- The Value of a Terminated Lease to the Landlord

When a lease is terminated, the landlord receives a possessory interest in the property for the duration of the lease. The value of this possessory interest is reduced by the present value of the rent that the landlord will not receive as a result of the lease termination. Consider again a ten-year lease with monthly rent payments. The tenant terminates the lease five years in, leaving sixty remaining rent periods. The landlord is able to re-lease the property for \$12,000 a month, \$2000 more than the former tenant was paying. The tenant basically receives \$600,000 in return for a \$720,000 property interest; and the landlord receives a windfall of \$120,000.

If the tenant later enters bankruptcy, the bankruptcy trustee may want to recover the lease to assign it to a third party, for \$12,000 a month, to raise cash for the tenant-debtor's unsecured creditors. To that end, the trustee may be able to avoid the termination as a constructive fraudulent transfer, depending on whether the \$600,000 in excused rent obligations amounts to a reasonably equivalent value for the \$720,000 possessory interest.

- Section 365(C)(3)

Section 365(c)(3) restricts the trustee's ability to assume and assign the debtor's unexpired leases. It states that the trustee "may not assume or assign any executory contract or unexpired lease of the debtor . . . if . . . such lease is of nonresidential real property and has been terminated under applicable non-bankruptcy law prior to the order for relief." 64 So, where the debtor's lease has ended for some valid reason other than the completion of its term, the trustee may not assume or assign the lease to raise cash for the unsecured creditors. The initiation of bankruptcy does not resurrect leases validly terminated prior to the bankruptcy. See *In re Triangle Labs., Inc.*, 663 F.2d 463, 467–68 (3d Cir. 1981) ("[A] lease validly terminated prior to the institution of bankruptcy proceedings is not resurrected by the filing of the petition in bankruptcy and cannot therefore be included among the debtor's assets.") It follows that the trustee may not use section 548 to avoid such terminations—at least not if it wants to recover (assume) the lease itself.

Section 365(c)(3) was added to the Bankruptcy Code in 1984. See *Bankruptcy Amendments and Federal Judgeship Act of 1984*, Pub. L. No. 98–353, 98 Stat. 333 (codified as amended in scattered sections of 11 U.S.C. and 28 U.S.C.) The statute's legislative history shows that Congress added it specifically to help the occupants of shopping center retail space. Congress recognized that the interests of different businesses within the same shopping center are, to a great extent, connected; that the prolonged vacancy of one retail space negatively affects surrounding businesses; and that bankruptcy cases and the lawsuits arising from them can prolong the vacancies of shopping center space.

The problem, in a nutshell, was that shopping center occupants' bankruptcies were hurting their neighbors' businesses.

Section 365(c)(3) ameliorates the problem by making it easier for landlords to re-lease property previously occupied by tenants currently going through bankruptcy. See *Great Lakes II*, 816 F.3d 482, 485 (7th Cir. 2016) And this, for its part, reduces the amount of time that retail space stays vacant. In the absence of section 365(c)(3), the trustee could sue under section 548 and, potentially, assume and assign an unexpired lease even if the landlord has already re-leased or sold the property. Obviously, that would disturb the new tenant's occupancy and probably hurt the performance of its business. The risk of this happening would repel potential tenants, thus prolonging the property's vacancy. Section 365(c)(3) ostensibly eliminates this risk by preventing the trustee from assuming nonresidential leases terminated prior to bankruptcy.

The legislative history suggests that Congress added section 365(c)(3) specifically to protect shopping center occupants. But the text of section 365(c)(3) does not distinguish between types of nonresidential real property. And vacant commercial property negatively affects surrounding properties—and, in itself, represents foregone economic activity—whether or not it lies in a shopping center. Thus, section 365(c) (3) applies with equal force

and with good reason to every kind of nonresidential property.

❖ Some Case Law on Lease Terminations as Fraudulent Transfers, Including The Scope Of Section 365(C)(3)

The relevant case law is split into two groups. One supports the position that nonresidential lease terminations can be fraudulent transfers. The other supports the opposite position: that nonresidential lease terminations cannot be fraudulent transfers.

• Nonresidential Lease Terminations Can Be Fraudulent Transfers

We look first at the cases that say a nonresidential lease termination can be a fraudulent transfer. *In re Queen City Grain, Inc. (Queen City)* is one of them. 51 B.R. 722 (Bankr. S.D. Ohio 1985). There, the tenant-debtor and the landlord were related corporations. Soon after they entered their lease agreement, both corporations found themselves in financial trouble. They held a meeting and decided that the landlord would sell all of its properties, including the property it was leasing to the tenant-debtor. The landlord found a buyer and agreed to sell its properties. While the landlord and the buyer were negotiating the sale, the buyer requested that the tenant-debtor's lease be terminated, and the landlord told the buyer that it could see to the lease's termination. The tenant-debtor and landlord subsequently discussed the lease's termination, after which the landlord sent the tenant-debtor a letter stating that the lease was terminated for rent default. The letter requested the tenant-debtor's consent to the termination, and the tenant-debtor gave it.

After the tenant-debtor declared bankruptcy, the trustee sued the buyer under section 548 to recover the lease, arguing that the lease termination was a constructive fraudulent transfer. The court found that the termination was a transfer under the Bankruptcy Code simply because it was a "parting with . . . an interest in property." But the court ultimately ruled for the buyer because the buyer successfully proved the good-faith defense under section 550(b). The court never discussed section 365(c)(3).

In *In re Edward Harvey Co. (Harvey)*, 68 B.R. 851 (Bankr. D. Mass. 1987). too, a nonresidential lease termination was a fraudulent transfer. But in contrast to *Queen City*, *Harvey* discussed section 365(c)(3) and its apparent tension with section 548. In *Harvey*, the tenant-debtor and the landlord entered an agreement to terminate their lease agreement before the completion of the lease's term. After the tenant-debtor declared bankruptcy, the trustee sued the landlord under section 548 to recover the lease, arguing that the lease termination was a constructive fraudulent transfer. The factual record contained no evidence that the landlord re-leased or sold the property.

The court ruled for the trustee for these reasons. First, the lease termination satisfied the Bankruptcy Code's definition of transfer. And second, section 365(c)(3) did not apply to the facts of the case because the lease termination violated section 548 and, therefore, could not have been executed in compliance with state law.

This second reason implies that section 365(c)(3) does not apply where section 548 has been violated. But this definitely proves too much. If section 365(c)(3) never applies where section 548 has been violated, then section 365(c)(3) is basically a dead letter. This becomes clear when we consider that, practically speaking, the only time section 365(c)(3) need apply is when the lease termination is otherwise potentially avoidable. Suppose the tenant-debtor terminates a lease whose cost in rent exceeds its value to the tenant-debtor. Since the lease is a “loser,” its termination cannot be a fraudulent transfer. And precisely because it is a loser, the trustee will not attempt to assume it. But if the lease is a “winner,” then, according to Harvey, the trustee may be able to use section 548 to avoid the termination and assume the lease, rendering section 365(c)(3) ineffective in the very situation it is meant to have effect.

- Nonresidential Lease Terminations Cannot Be Fraudulent Transfers

Other cases seem to stand for the proposition that a nonresidential lease termination cannot be a fraudulent transfer. We look first at *Haines v. Regina C. Dixon Trust (Haines)*. 178 B.R. 471 (Bankr. W.D. Mo. 1995). There, the tenant-debtor defaulted on its lease. In response, the landlord obtained a state court judgment terminating the lease. As debtor-in-possession, the tenant-debtor sued the landlord, under section 548, to recover the lease. The court ruled for the landlord, reasoning that section 365(c)(3) prohibited the debtor-in-possession from assuming the lease. The court explicitly refused to follow Harvey: Since section 365(c)(3) is more specific than section 548, it reflects Congress’s intent that section 365(c)(3) control in cases where the two statutes conflict. Following Harvey would have rendered section 365(c)(3) meaningless and, in this way, frustrated Congress’s intent.

The court stated that section 365(c)(3) was dispositive but proceeded still to say that the lease termination was not a transfer for section 548’s purposes. It distinguished the termination before it from the ones in Harvey and Queen City. In Harvey, the tenant-debtor and the landlord agreed to terminate the lease. By contrast, in Haines, the termination occurred because the tenant-debtor defaulted. Once the state court handed down its judgment terminating the lease, the tenant-debtor’s leasehold interest ceased to exist. Quite simply, the tenant-debtor had no interest in property to transfer. And in Queen City, even though the termination occurred by reason of default, the close relation between the tenant-debtor and landlord suggested an element of collusion not present in Haines.

Next, *In re Egyptian Brothers Donut, Inc. (Egyptian Bros.)* 190 B.R. 26 (Bankr. D.N.J. 1995). is another case in which section 365(c)(3) prohibited the debtor-in-possession from using section 548 to recover a terminated nonresidential lease. As in Haines, the tenant-debtor defaulted on its lease and the landlord obtained a state court judgment terminating it. The court claimed to rely on Haines, but its reasoning differed in a meaningful way. Remember that in Haines, the court concluded that the lease termination was not a transfer, and that even if it was, section 365(c)(3) prohibited the debtor-in-possession from using section 548 to assume the lease. The Haines decision implied, pretty clearly, that a termination can be a transfer despite the application of section 365(c)(3). By contrast, in *Egyptian Bros.*, the lease termination was not a transfer precisely because section 365(c)(3) applied. The court acknowledged that a literal reading of the definition of transfer includes lease terminations but chose not to read the definition too literally because doing so would have brought sections 548 and 365(c)(3) into conflict.

I argue that the termination truly was not a transfer. But the court's argument was, frankly, wrong. Instead of saving sections 548 and 365(c)(3) from conflict, it created conflict between them.

Great Lakes -- *In re Great Lakes Quick Lube Ltd. P'ship (Great Lakes I)*, 528 B.R. 893, 894 (Bankr. E.D. Wis. 2015), rev'd sub nom. *Great Lakes II*, 816 F.3d 482 (7th Cir. 2016)

In *Great Lakes*, the tenant-debtor agreed with its landlord to terminate several leases early. After the tenant-debtor declared bankruptcy, a committee made up of its creditors sued the landlord, under section 548, alleging that two of the terminations were constructive fraudulent transfers. The landlord had since re-leased the properties to a new tenant. The creditors' committee did not want to assume the leases; instead, it wanted to recover the value of the leases. At trial, the bankruptcy court ruled for the landlord. Relying mainly on *Egyptian Bros.*, the court held that section 365(c)(3) applied and, for that reason, the terminations were not fraudulent transfers under section 548.

On appeal, the Seventh Circuit reversed. *Great Lakes II*, 816 F.3d at 486. First, Judge Posner discussed the Bankruptcy Code's definition of transfer. Relying solely on the text of section 101(54)(D), he concluded that transfer necessarily covered the lease terminations before him. He rejected the landlord's argument that the terminations amounted to abandonments of the property and, therefore, were not transfers, on the ground that even abandonments of property satisfy the definition of transfer.

After determining that the terminations were transfers, Judge Posner addressed the apparent conflict between sections 548 and 365(c)(3). Emphasizing section 365(c)(3)'s purpose, he concluded that it prohibits the trustee (in this case, the creditors' committee) from selling a lease to someone who as lessee would be able to occupy the property. Since the landlord had re-leased the properties to a new tenant, the creditors' committee could not assume and sell the leases. But the creditors' committee did not want to assume the leases. Instead, it wanted to take advantage of section 550(a)'s money judgment option to recover the value of the leases. Since recovering the value would not result in the new tenant's eviction, section 365(c)(3) did not apply.

Judge Posner's opinion was short and to the point. Its brevity downplays the highly innovative nature of its reasoning. In ruling that the creditors' committee could sue under section 548 to recover the value of the leases from the landlord, Judge Posner implied a free disconnection between in rem and in personam recoveries. That is, where section 365(c)(3) makes the lease itself unrecoverable, the trustee may sue the defendant-transferee (the landlord, at least) for the lease's value.

- Rethinking Lease Terminations as Fraudulent Transfers, Including the Scope of Section 365(c)(3)
- Though it may appear inconsistent, the relevant case law can, for the most part, be reconciled.
- Using "Control" To Determine Which Lease Terminations Are "Transfers"

Read literally, section 101(54)(D)'s definition of transfer strongly seems to include lease terminations. *Queen City*, *Harvey*, and *Great Lakes* all thought so. But a lease termination can also be viewed, quite reasonably, as the happening of a condition subsequent that divests the tenant-debtor of its interest in the property. Under this view, lease terminations are not transfers at all, because the divestment leaves the tenant-debtor without any interest in property to transfer. This, basically, was the view of the court in *Haines*.

These views can be reconciled using a "control" standard. Very simply, where the tenant-debtor had control of the property, the lease termination amounts to a transfer. But where the tenant-debtor did not have control of the property, the termination amounts to the occurrence of a condition subsequent, not a transfer.

This control standard can be drawn from *Drye v. United States*. 528 U.S. 49 (1999). As the Supreme Court held in *Drye*, a taxpayer who disclaimed an inheritance did not, by doing so, prevent federal tax liens from attaching to the inheritance. The Supreme Court emphasized the taxpayer's practical control over the disposition of the

decendent's estate: since the taxpayer had the unqualified right to choose between receiving the inheritance and disclaiming it, the inheritance was property within the meaning of the relevant statute and, therefore, subject to federal tax liens.

The utility of the control standard, as applied to lease terminations, becomes clear when applied retrospectively to the cases already discussed. In *Harvey* and in *Great Lakes*, the tenant-debtor had the unqualified right to choose between terminating its lease and not terminating it. These tenant-debtors had control over the fate of their leases. So, by choosing to terminate the leases, the tenant-debtors made a transfer of their interest in the property.

By contrast, the tenant-debtor in *Haines* defaulted, and this was the basis for the state court's judgment terminating the lease. The tenant-debtor did not have the absolute right to choose between terminating the lease and not terminating it. The tenant-debtor lacked control of the lease because the state court had already decided the lease's fate. For this reason, the termination was not a transfer, but the happening of a condition subsequent that divested the tenant-debtor of its property interest. The tenant-debtor in *Egyptian Bros.* similarly lacked control, and the court should have found that the termination at issue was not a transfer for this reason. But instead, the court said the termination was not a transfer simply because section 365(c)(3) applied. This created a needless conflict between section 365(c)(3) on the one hand, and sections 101(54)(D) and 548 on the other.

In *Queen City*, the tenant-debtor appeared to lack control because the lease termination occurred, formally, by reason of the tenant-debtor's default. But, as noted in *Haines*, the facts surrounding the tenant-debtor's default strongly suggested collusion between the tenant-debtor and the landlord. 51 B.R. 722, 724 (Bankr. S.D. Ohio 1985) If the parties actually colluded to terminate the lease, then the tenant-debtor did, in fact, have control of the lease, and the termination was a transfer. And even if there was no collusion, the tenant-debtor may have had control of the lease. Remember that the tenant-debtor consented to the lease's termination. Instead, it could have contested the landlord's letter of

termination in court. So, by consenting to the lease's termination before the lease was terminated by court judgment, the tenant-debtor arguably exercised the requisite control, making the termination a transfer.

Using this control standard may create an incentive for collusion between related tenant-debtors and landlords. They may (as they might have in Queen City) try to conceal the tenant-debtor's control of the lease in order to avoid a court-finding that the lease termination was a transfer. Combatting collusion of this sort is the province of actual fraudulent transfer. Trustees can prove such collusion using the badges of fraud, as they would any alleged actual fraudulent transfer. *In re MarketXT Holdings Corp.*, 376 B.R. 390, 402–12 (Bankr. S.D.N.Y. 2007) (finding that the trustee made a prima facie case for actual fraudulent transfer, under section 548, by providing evidence of several “badges of fraud,” including “[a] close relationship between the parties to the alleged fraudulent transaction” and “[c]oncealment of facts and false pretenses by the transferor”). So any potential incentive for collusion is not reason enough to forego using the control standard.

- Reconciling Sections 548 And 365(C)(3)

These hypothetical cases assume that the tenant-debtor exercised the requisite control, leaving no doubt that the terminations are transfers for section 548's purposes.

- New Tenant Who Takes in Good Faith

To facilitate re-leasing, section 365(c)(3) protects the new tenants of commercial property from having their occupancies disturbed by former tenants' bankruptcy cases. For this reason, it might seem necessary to apply section 365(c)(3) whenever the landlord re-leases the property to a new tenant. But if the new tenant leases the property in good faith, section 365(c)(3)'s purpose can be fulfilled without having to apply the statute.

Consider these facts. The tenant-debtor and the landlord agree to terminate the tenant-debtor's lease. The landlord then re-leases the property to a new tenant, who takes for value and in good faith. The trustee is able to prove a prima facie case of constructive fraudulent transfer. But the new tenant can prove the section 550(b) defense, making its interest in the leased property superior to the trustee's. And so, the trustee cannot recover the lease itself from the new tenant—not because of section 365(c)(3), but because section 550(b) protects the new tenant's interest.

But the initial transfer from the tenant-debtor to the landlord is no less fraudulent because of the subsequent transfer from the landlord to the new tenant. The trustee simply cannot recover the lease itself. The lease's unrecoverability resulted from the landlord re-releasing the property. In essence, the landlord converted the lease. Since the lease was made unrecoverable by the landlord's conversion of it, the trustee can, under section 550(a), secure a money judgment for the value of the lease.

Queen City illustrates these points. There, the trustee could not recover the lease itself because the landlord's transferee proved the section 550(b) defense. The court did not discuss section 365(c)(3) because it did not have to. Had the trustee and the landlord not settled their dispute out of court, See *In re Queen City*, 51 B.R. at 725, the trustee could have sued the landlord to recover the value of the lease because the landlord made the lease

unrecoverable by selling it to an innocent transferee. The landlord could have been held liable for converting the lease—or, more accurately, for conduct tantamount to converting the lease.

- New Tenant Who Takes in Bad Faith

If the new tenant cannot prove the good-faith defense under section 550(b), then the trustee would have a winning case against the new tenant but for the application of section 365(c)(3), which operates to prevent the trustee from avoiding the termination and recovering the lease itself. Here, sections 548 and 365(c)(3) inescapably conflict. And since section 365(c)(3) is more specific than section 548, section 365(c)(3) should govern. See *RadLax Gateway Hotel, L.L.C. v. Amalgamated Bank*, 566 U.S. 639, 645 (2012).

But just because the in rem option fails does not mean the in personam option must fail, too. Not under *Great Lakes*, at least. There, the failure of the in rem option opened up the option, under section 550(a), of securing a money judgment against the landlord. By making the in personam option available to the creditors' committee, Judge Posner used section 550(a) to give effect both to section 548 and section 365(c) (3). This is not only a reasonable reading of section 550(a). It is the correct reading, because it enables courts to satisfy the well-established principle that they shall, where possible, give effect to every part of a statutory scheme. See *In re Asher*, 488 B.R. 58, 69 (Bankr. E.D.N.Y. 2013).

- No New Tenant

As written, section 365(c)(3) fails to distinguish between leases relating to property that has been re-leased or sold, and leases relating to property that has not been re-leased or sold. It therefore prevents the trustee from assuming and assigning a lease even if the landlord has not re-leased or sold the property. This prohibition is not needed to fulfill section 365(c)(3)'s purpose. In some cases, it may even defeat that purpose.

Suppose the trustee wants to assume the lease because the trustee has determined it will help raise cash for the unsecured creditors. Here, the trustee's assuming the lease will not disrupt the occupancy of the property's new tenant because there is no new tenant. In fact, preventing the trustee from recovering the lease may prolong the property's vacancy. Presumably, the trustee plans to put the property to profitable use. Otherwise, the trustee would not try to recover the lease because the game would not be worth the candle. So, by preventing the trustee from recovering idle property, section 365(c)(3), as written, stands to defeat its own purpose. The trustee should be able to sue the landlord under section 548 to assume the lease.

This situation basically mirrors *Harvey*—assuming, of course, that the property in *Harvey* really had not been re-leased or sold at the time of litigation. In deciding that the lease termination violated section 548, *Harvey* reached the right outcome because it properly applied section 548 without defeating the purpose of section 365(c)(3). But it reached the decision for the wrong reason. Remember that, in *Harvey*, section 365(c)(3) did not apply simply because the termination violated section 548. But as previously stated, this proves too much. If section 365(c)(3) never applies to terminations that violate section 548, then section 365(c)(3) is a mostly ineffective statute. Instead, *Harvey* should have decided that section 365(c)(3) did not apply because there was no new tenant. That way, it

would have reached the right decision without creating needless conflict between sections 548 and 365(c)(3).

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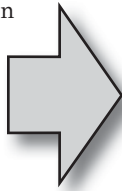
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On or before 9/19/15	Nov.–March	\$335.00	\$268.00
	April–June	252.00	201.00
	July–Sept.	168.00	134.00
	Oct.–Dec.	84.00	67.00
9/20/15 thru 9/19/16	Nov.–March	\$268.00	\$215.00
	April–June	201.00	162.00
	July–Sept.	134.00	108.00
	Oct.–Dec.	67.00	54.00
9/20/16 thru 9/19/17	Nov.–March	\$201.00	\$161.00
	April–June	151.00	121.00
	July–Sept.	101.00	81.00
	Oct.–Dec.	51.00	41.00
9/20/17 thru 9/19/18	Nov.–March	\$134.00	\$108.00
	April–June	101.00	81.00
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