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EYE ON BANKRUPTCY

Educational Materials
September 2018

SEASON 4 · EPISODE 9

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EYE ON BANKRUPTCY

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BAP opinion shows that contempt is virtually impossible to prove in the Ninth Circuit following Taggart.

BAP opinion shows that contempt is virtually impossible to prove in the Ninth Circuit following Taggart.

The Ninth Circuit ruled in April that a good faith belief that an action does not violate the discharge injunction precludes finding the creditor in contempt, even if the discharge injunction did apply and the creditor's belief was "unreasonable." *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438 (9th Cir. April 23, 2018). *Taggart* means that contempt will be difficult if not impossible to prove in the Ninth Circuit.

On September 7, the appeals court denied a petition for rehearing and rehearing *en banc* in *Taggart*. The circuit court was not persuaded by several *amicus* briefs submitted by law professors, professional organizations, and a former judge, all urging rehearing.

Daniel L. Geyser of Dallas, the debtor's counsel on the rehearing motion in *Taggart*, told ABI that he will be filing a petition for *certiorari* in the Supreme Court. He said there is "a square circuit conflict over a recurring question that is essential to the Code's effective administration." If allowed to stand, he said that *Taggart* "will eviscerate the Code's key mechanism for enforcing the discharge injunction."

Indeed, there is little to deter stay violations without the threat of contempt, and debtors may not be able to afford counsel to enforce their protections if contempt sanctions are generally unavailable.

The First Circuit widened the circuit split in June in deciding *IRS v. Murphy*, 892 F.3d 29 (1st Cir. June 7, 2018).

In *Murphy*, a divided panel on the Boston-based appeals court ruled less than two months after *Taggart* that a government employee who knows there was a discharge may be held in contempt even if the government had a good faith belief that the action did not violate the discharge. Contempt may be found, the First Circuit said, so long as there was an intentional action later found to violate the discharge. To read ABI's discussions of *Taggart* and *Murphy*, click here and here.

Meanwhile, the Ninth Circuit Bankruptcy Appellate Panel handed down an opinion on September 7 interpreting *Taggart* and showing that contempt will be virtually impossible to establish in the Ninth Circuit, even when there has been an adjudicated stay violation.

The BAP's September 7 opinion in *RESS Financial Corp. v. Beaumont 1600 LLC (In re The Preserve LLC)* demonstrates the importance of resolving the circuit split, given the centrality of discharge and the automatic stay in the bankruptcy system.

Before bankruptcy, the corporate debtor in *Preserve* had purchased about 1,300 acres encumbered by a mortgage for almost $40 million. Also before bankruptcy, the lender released the lien on about half of the acreage.

In connection with confirmation of the debtor's chapter 11 plan, the bankruptcy court entered an order declaring that the collateral for the mortgage was 636 acres, representing the original acreage less the portion that was released. The confirmed plan also stated that the collateral was 636 acres.

The debtor defaulted on the plan the following year, resulting in conversion to chapter 7 and the appointment of a trustee. The conversion order lifted the automatic stay to permit foreclosure of the lender's deed of trust.

The lender and its agent both concluded that the release of lien was invalid because it was not accompanied by a recorded map, as allegedly required by California law. The lender's agent therefore initiated foreclosure proceedings with respect to the entire 1,300 acres. Counsel for the chapter 7 trustee quickly demanded that the lender terminate the foreclosure proceedings with regard to the released acreage.

When the lender responded by saying it would not stand down, the trustee initiated an adversary proceeding, asking the bankruptcy judge to declare that the foreclosure proceedings were invalid with respect to the released acreage. The trustee also sought damages for violation of the automatic stay. Without conceding error, the lender then discontinued the foreclosure proceedings.

Litigation continued in the bankruptcy court for more than two years. Following trial, the bankruptcy judge ruled that the lender had committed a willful and intentional violation of the automatic stay after having been informed by the trustee's counsel that the stay protected the property that had been released from lien.

The bankruptcy judge determined that the lender's belief about the inapplicability of the automatic stay was reckless and unreasonable. Ultimately, the bankruptcy court

found the lender in contempt and entered judgment in favor of the trustee for about $425,000, representing legal fees incurred by the trustee in litigating the alleged automatic stay violation and related issues.

The lender appealed to the BAP and won.

In a *per curiam*, nonprecedential opinion on September 7, the BAP reversed and remanded the case to the bankruptcy court, ostensibly to determine whether the trustee had established by clear and convincing evidence that the lender had knowledge of the stay and committed a willful violation.

Although the trustee theoretically will have a second bite at the apple on remand, the trustee's chances of prevailing are small because the BAP went on to cite *Taggart* by saying that "a good faith belief that the stay does not apply precludes a finding of contempt, even if the creditor's belief is unreasonable." The bankruptcy court's finding about the lender's unreasonable belief presumably will not support a contempt citation, because *Taggart* says that even an unreasonable belief elides a contempt finding.

Indeed, the lender's good faith belief about the inapplicability of the stay seems beyond cavil because the lender had received several opinions saying that the release of lien was invalid.

Whether or not *Taggart* is set aside in the Supreme Court, *Preserve* will remain required reading because the BAP's opinion is a virtual handbook containing a step-by-step compendium of rules pertaining to contempt citations. Among other things, the opinion highlights the differences between a finding of contempt under the court's inherent powers contrasted with Section 362(k), which applies only to individual debtors complaining about stay violations.

The BAP opinion applies *Taggart* to automatic stay violations, removing any thought that *Taggart* would only govern violations of the discharge injunction.

The BAP opinion is not intended for official publication, but it should be officially published, in this writer's opinion. The opinion is a priceless synthesis of rules pertaining to contempt findings.

Opinion Link

Third Circuit creates a high standard for revoking a vested contract right.

Third Circuit Upholds Revocation of $275 Million Breakup Fee

In what it called an “anomalous” case, the Third Circuit upheld the revocation of a $275 million breakup fee because the bankruptcy judge had “failed to discern a critical fact that profoundly altered the underlying legal determination.”

The 2/1 opinion on September 13 is a meticulous exploration of the law governing reconsideration. In the future, another buyer is unlikely to be deprived of a seemingly vested breakup fee, because the appeals court said “our conclusion may very well have been different” if the underlying facts were “anything less.”

The Genesis of the Breakup Fee

Laying the groundwork for emerging from a chapter 11 reorganization, electric energy giant Energy Future Holdings Corp. negotiated an agreement to sell its Oncor regulated electric distribution business for a price that would have brought $9.5 billion into the estate. The agreement included a $275 million breakup or termination fee payable to the purchaser.

At the approval hearing, Bankruptcy Judge Christopher S. Sontchi of Delaware was told the buyer would not earn the termination fee if state regulators were to refuse to approve the sale and the buyer terminated the agreement. The agreement gave the breakup fee to the buyer if the debtors were to terminate the agreement for almost any reason.

Later, Judge Sontchi said that no one had told him that the buyer “would never be required to terminate and could simply wait for mounting financial pressure to force the debtors to” terminate instead.

Judge Sontchi approved the purchase agreement and the breakup fee in September 2016, but state regulators did not disapprove the sale until April 2017. Judge Sontchi said the deal was “clearly dead” when regulators refused to give approval a second time in late June 2017.

After the second rejection by regulators, the debtors terminated the agreement. At that juncture, the buyer seemed entitled to the $275 million breakup fee because the agreement, as it was written, called for the payment if the debtors terminated, even though regulators had disapproved the acquisition. The agreement had no deadline for the buyer to obtain regulatory approval.

At the end of July 2017, several creditors filed a motion for reconsideration, asking Judge Sontchi to revoke approval of the termination fee that he had granted in September 2016.

Ruling on the creditors' motion for reconsideration, Judge Sontchi said it "became clear" after the second disapproval that the purchaser would appeal the regulators' decision "to all levels of review, leaving the debtors no choice but to terminate" the sale agreement and "risk triggering the termination fee or else incur months or years of continued interest and fee obligations."

In his opinion in October 2017 revoking approval of the breakup fee, Judge Sontchi said the debtor had been "forced to terminate the [purchase] agreement [in July 2017] to pursue a lower offer because [the purchaser] had the debtor in a corner." The Third Circuit accepted a direct appeal, overstepping an intermediate appeal in district court.

Time Limits for Reconsideration

There may or may not have been a time limit for reconsideration, depending on the nature of the approval order.

Writing for the majority, Circuit Judge Joseph A. Greenaway, Jr. said that federal courts have inherent authority to permit reconsideration, although there is no express authorization in the rules. If the approval order was interlocutory, he said there would be "no strict time limit" regarding reconsideration.

On the other hand, if the creditors' motion were under Rule 60(b) based on fraud or mistake, Judge Greenaway said the time limit would be one year under Rule 60(c), made applicable by Bankruptcy Rule 9024.

To decide that Rule 60(b) did not apply, Judge Greenaway concluded that the approval order was interlocutory, considering the "flexible, pragmatic approach to finality in the bankruptcy context." The initial order was interlocutory, he said, because the allocation of the breakup fee among the debtors' estates was left to later determination. The order was also interlocutory because the bankruptcy court reserved jurisdiction to resolve disputes.

Even if the order was interlocutory and gave rise to no explicit time restriction, Judge Greenaway said that the doctrine of *laches* could make reconsideration untimely. However, he found no abuse of discretion by the bankruptcy judge in refusing to bar the reconsideration motion based on *laches* because the creditors acted within weeks of the termination of the acquisition.

The Merits of Reconsideration

Having decided there was no time bar, Judge Greenaway turned to the merits of the decision to reconsider and the legal standards to be applied.

Although reconsideration based on the court's inherent power gives rise to no rigid set of rules, Judge Sontchi had applied the standards under Rule 59(e), made applicable by Bankruptcy Rule 9023. A motion under Rule 59(e) requires a clear error of law or fact. Saying that Judge Sontchi's approach "makes sense," Judge Greenaway employed the same standard.

According to Judge Greenaway, Judge Sontchi concluded that he "had a fundamental misunderstanding of the critical facts." In particular, Judge Sontchi had not been told there was no time limit within which the buyer was required to obtain regulatory approval.

"Despite this heightened standard," Judge Greenaway said that appellate review of a motion for reconsideration is for abuse of discretion. With regard to the bankruptcy court's subjective understanding of the deal, he concluded that the findings were not clearly erroneous.

By misunderstanding the facts, Judge Greenaway said that Judge Sontchi "failed to weigh this potential harm to the estates [the requirement to pay $275 million] against the potential benefits." He said "the error of fact was obvious and indisputable," leading the bankruptcy judge to improperly weight the factors to consider when approving a breakup fee under Third Circuit precedent.

"Looking at the totality of the circumstances," Judge Greenaway said that the bankruptcy court "did not abuse its discretion" in disapproving the breakup fee after correctly understanding the facts.

The Dissent

Finding an abuse of discretion, Circuit Judge Marjorie O. Rendell dissented. Although the bankruptcy judge may have misapprehended the facts, she said, "this was no legal

or factual error." She said that "hindsight cannot justify nullifying a material term of the deal." In her view, "the parties fully appreciated the potential scenarios" when the bankruptcy judge was approving the breakup fee.

Judge Rendell concluded by saying that reconsideration "based on a bankruptcy court's failure to appreciate all of the potential ramifications of the terms sets a troubling — if not dangerous — precedent."

Judge Rendell seems to believe that the parties' correct understanding of the deal mattered, while the majority focused on the bankruptcy judge's misunderstanding. Neither the majority nor the dissent analyzed whether the bankruptcy judge had been intentionally misled, possibly because Judge Sontchi did not lay blame in his opinion.

To justify reconsideration in the future and avoid the high standard in the Third Circuit, the party seeking reconsideration should attempt to prove that someone misled the bankruptcy court, whether intentionally or not.

Opinion Link

***Thomas Ambro on the Third Circuit answers a question the Supreme Court left open in* Henson v. Santander.**

FDCPA Applies to Debt Collectors Even if They Own the Debt

The Third Circuit jumped through a loophole the Supreme Court left open intentionally in *Henson v. Santander Consumer USA Inc.*, 137 S. Ct. 1718 (2017), by holding a debt purchaser is subject to the federal Fair Debt Collection Practices Act, or FDCPA, if its principal business is the collection of debts.

In *Henson*, the maiden opinion by newly-appointed Justice Neil M. Gorsuch, the headline holding was: Someone who purchases a defaulted debt is not a "debt collector" and is therefore not subject to the FDCPA, 15 U.S.C. § 1692, *et seq*.

A bank in *Henson* had purchased a debt already in default that had been originated by another lender. The opinion was often (but incorrectly) interpreted to mean that the FDCPA can never apply to a debt collector who has purchased a defaulted debt for its own account. However, Justice Gorsuch was careful to highlight two questions the Court did not decide:

1. The debtor argued that the bank came within the FDCPA because it regularly collected debts for another. Justice Gorsuch said that question was not raised in the petition for *certiorari*, and the Court did not agree to review it; and
2. Justice Gorsuch said the Supreme Court had not agreed to address another aspect of the definition of a debt collector in Section 1692a(6), which includes someone "in any business the principal purpose of which is the collection of any debts."

In his August 7 opinion for the Third Circuit based on the "plain text" of the statute, Circuit Judge Thomas L. Ambro latched onto the second unresolved question by holding that the FDCPA applies to "an entity whose principal purpose of business is the collection of any debts . . . regardless of whether the entity owns the debts it collects."

The Facts in the Third Circuit

The facts on the appeal before Judge Ambro were similar to those in *Henson*, except that the plaintiff in *Henson* had not argued below that the bank's principal business was debt collection.

In the Third Circuit, the plaintiffs owned a home subject to a mortgage owing to a bank taken over by the Federal Deposit Insurance Corp. Initially, they continued making monthly payments after the takeover, but the FDIC neither cashed nor returned the checks. Eventually, the plaintiffs stopped sending monthly checks.

The FDIC declared the loan in default and sold it to a purchaser who demanded payment in full in an amount more than the plaintiffs owed. Having made several communications that might violate the FDCPA, the purchaser initiated foreclosure proceedings.

The homeowners filed suit in district court, alleging violations of the FDCPA. In several pleadings, the defendant-purchaser admitted that its sole business was acquiring and collecting debts.

Following a bench trial but before the district court rendered its decision, the Supreme Court handed down *Henson*. After additional briefing, the district court ruled that the purchaser was a debt collector and was liable for having violated the FDCPA.

The purchaser appealed, contending in the Third Circuit that it was not a debt collector subject to the FDCPA because it owned the debt.

Judge Ambro's Analysis

The FDCPA applies to a "debt collector" but not to a "creditor." A "debt collector" is defined as someone who uses the mails or interstate commerce "in any business the principal purpose of which is the collection of any debts" or someone "who regularly collects" debts owed to "another." 15 U.S.C. § 1692a(6).

A "creditor" under the FDCPA is someone who extends credit or is someone "to whom a debt is owed." The term "creditor" excludes "any person to the extent that he receives an assignment or transfer of a debt in default solely for the purpose of facilitating collection of such debt for another." 15 U.S.C. § 1692a(4) and (6).

Before *Henson*, the law in the Third Circuit followed the so-called default test in *Pollice v. National Tax Funding L.P.*, 225 F.3d 379, 403 (3d Cir. 2000), where the purchaser of a debt is a debt collector subject to the FDCPA if the debt was purchased after default.

Under *Pollice*, the purchaser in Third Circuit appeal would have been a "debt collector," but Judge Ambro said that *Henson* "recently repealed the 'default' test we followed."

Judge Ambro said that only one circuit court since *Henson* has ruled on the FDCPA in a precedential opinion. In that case, the District of Columbia Circuit held that the defendant was not a debt collector because there was no evidence that the bank's principal business was the collection of debt or that it was collecting the debt for someone else.

Addressing "the task before us today," Judge Ambro said that no circuit has issued a precedential opinion "on *Henson*'s applicability to the 'principal purpose' definition of 'debt collector.'" Picking what *Henson* held and what it did not hold, he said that *Henson* "affects" but "did not decide" who "fits the 'principal purpose' definition of 'debt collector.'"

Judge Ambro said that the phrase "any debt" as used in the statute does "not distinguish to whom the debt is owed." In contrast, he said, "debts owed or due . . . another" only applies to the "regularly collects" definition.

Contending that it could not be a debt collector because it also met the definition of creditor, the purchaser in substance argued that the definitions are mutually exclusive. Judge Ambro rejected the argument because, "following *Henson*, an entity that satisfies both is within the [FDCPA's] reach."

Whether the defendant owns the debt, Judge Ambro said, "does not resolve whether that entity is a debt collector." Because the purchaser conceded that its principal business was collecting debts, Judge Ambro held that the debt buyer was subject to the penalties in the FDCPA because it was a "debt collector under the 'principal purpose' definition."

To read ABI's discussion of *Henson*, click here.

Opinion Link

Eleventh Circuit abandons the notion that new value must remain unpaid to offset a preference.

Circuit Split Narrows on the New Value Defense to a Preference

Narrowing a split among the circuits, the Eleventh Circuit no longer requires that new value remain unpaid on filing to qualify as a defense to a preference.

As it now stands, the Fourth, Fifth, Eighth, Ninth and Eleventh Circuits do not limit the new value defense to subsequent advances of credit that remain unpaid on the filing date. According to the August 14 opinion by Eleventh Circuit Judge Julie E. Carnes, "the Seventh Circuit held, without much discussion, that Section 547(c)(4) does require new value to remain unpaid."

Similarly, she said that the Third Circuit "also stated in a conclusory fashion [in *dicta*] that Section 547(c)(4) requires new value to remain unpaid."

In reality, the Eleventh Circuit was not reversing a prior holding. Judge Julie Carnes, not to be confused with Chief Judge Ed Carnes, said that her court's prior statement in *Charisma Investment Company N.V. v. Airport Systems Inc. (In re Jet Florida System Inc.)*, 841 F.2d 1082 (11th Cir. 1988), was *dicta* and therefore was not binding.

Commenting on Judge Carnes' opinion, Charles Tatelbaum of Miami told ABI, "It's about time."

The Facts in the Eleventh Circuit

The appeal to the Eleventh Circuit involved a typical preference, albeit for big bucks. The supplier to a chain of grocery stores was paid more than $550,000 in the 90-day preference period before bankruptcy. Also during the preference period, the supplier provided new value by delivering goods worth some $435,000.

The supplier conceded that the payments satisfied all of the elements of a preference under Section 547(b).

However, the supplier raised the so-called ordinary course defense under Section 547(c)(2) and the new value defense under Section 547(c)(4). The bankruptcy court rejected the ordinary course defense.

Relying on *Jet Florida*, the bankruptcy court did not allow the supplier to offset new value that the debtor had paid before filing. As a result, the bankruptcy court held the supplier liable for a net of about $440,000 in preferences. Had the defense been allowed, it is possible that the supplier may have had no preference liability at all.

The bankruptcy court certified a direct appeal, which the Eleventh Circuit accepted. The supplier only raised the new value defense on appeal.

Jet Florida's *Dicta*

In *Jet Florida*, the creditor had raised the new value defense under Section 547(c)(4), which allows a creditor to offset "new value" given after a preferential transfer that was "(A) not secured by an otherwise unavoidable security interest; and (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor."

The bankruptcy court in *Jet Florida* concluded that the creditor had not given new value as a matter of fact. Agreeing that the creditor had not given new value, the circuit court in *Jet Florida* upheld the finding of a preference.

In the course of the decision, however, the Eleventh Circuit said that the new value defense has "generally been read to require . . . that the new value must remain unpaid." *Id.* at 1083.

Because the statement about remaining unpaid was not necessary to the decision in *Jet Florida*, Judge Carnes said it was *dicta* and was therefore not binding on the court.

Plain Language Saves the Supplier

Analyzing the issue anew, Judge Carnes said that the "plain language" of Section 546(c)(4) "does not require new value to remain unpaid." She also said that "policy considerations strongly disfavor the trustee's position" that new value must remain unpaid to provide an offset to a preference.

Judge Carnes found nothing in the language of Section 546(c)(4) allowing an offset "only for new value that remains unpaid." Instead, she said, the "plain language" in

subsections (A) and (B) allow the defense "so long as the transfer that pays for the new value is itself avoidable."

Judge Carnes buttressed her conclusion by analyzing the history of preferences. Under the predecessor to the current preference statute, Section 60c of Bankruptcy Act of 1898 said there was an offset for "such new credit remaining unpaid." The "remaining unpaid" language, she said, was omitted from the Bankruptcy Code, to be replaced by "something substantively different" in the confusing double negatives now found in subsections (A) and (B).

Judge Carnes cited the Commission on the Bankruptcy Laws of the U.S. for recommending before adoption of the Code that the "remaining unpaid" provision be eliminated.

Even if Congress had not intended to make a change from prior law, Judge Carnes said she would reach the same conclusion from "the unambiguous statutory language."

Policy Considerations Point in the Same Direction

Requiring new value to remain unpaid "would hinder the policy objective of encouraging vendors to continue extending credit to financially troubled debtors," Judge Carnes said. Otherwise, a supplier who senses financial trouble would have a "strong disincentive" to continue delivering goods, for fear that preference liability would increase.

Judge Carnes described a hypothetical where a supplier received $5,000 in payments and made $5,000 in advances during the preference period. If "remaining unpaid" were a requirement, the supplier would be liable for the entire $5,000. If it did not matter, the supplier's maximum liability would be $1,000, she said.

Giving suppliers incentives to cut off customers in financial trouble would hasten bankruptcy, while harming both the debtor and other creditors, Judge Carnes said.

The trustee made a virtually unintelligible argument based on the word "otherwise" in subsection (B). Judge Carnes said that no court had accepted the argument and some have rejected it.

Judge Carnes remanded the case to recalculate the amount of the preference, if any, for which the supplier would be liable.

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Opinion Link

Two circuits and a BAP now invoke 'equitable mootness' to dismiss appeals from orders confirming chapter 9 municipal debt adjustment plans.

Eleventh Circuit Endorses the Applicability of 'Equitable Mootness' in Chapter 9

Courts considering the issue are now unanimous: The doctrine of equitable mootness applies in chapter 9 just like it does in chapter 11 as the result of an August 16 Eleventh Circuit opinion in the wake of the Jefferson County, Ala., municipal bankruptcy.

The Jefferson County Chapter 9 Plan

Until Detroit sought chapter 9 protection in 2013, Jefferson County's filing in 2011 had been the largest-ever municipal bankruptcy. The county listed long-term debt of $4.23 billion, including about $3.2 billion in defaulted sewer bond debt where the bondholders could look only to the sewer system for payment. The county's chapter 9 plan, confirmed in November 2013, reduced sewer debt to about $1.8 billion from $3.2 billion.

To pay off the old sewer bondholders at a substantial discount, the county issued about $1.8 billion in new sewer bonds. The plan locked in rate increases to be paid by sewer customers every year for 40 years and gave the bankruptcy court continuing jurisdiction to compel the rate increases. The county implemented the plan a few days after confirmation, issuing new bonds in the process.

Ratepayers had objected to confirmation and appealed the confirmation order to the district court, but the county filed a motion to dismiss the appeal, arguing that the appeal should be dismissed on the grounds of equitable mootness.

District Judge Says No Equitable Mootness in Chapter 9

District Judge Sharon Lovelace Blackburn of Birmingham, Ala., wrote a 50-page opinion in September 2014 denying the motion to dismiss the appeal. She held that equitable mootness was not applicable in a chapter 9 municipal bankruptcy, although she said that "some parts of the confirmation order may be impossible to reverse," such as the validity of the newly issued bonds.

Still, reversal meant that she might later void the provisions in the plan locking in annual rate increases that had been included for the benefit of the purchasers of the new sewer bonds.

Judge Blackburn allowed an interlocutory appeal, resulting in the August 16 opinion by Circuit Judge Adalberto Jordan.

Eleventh Circuit Joins Two Other Courts

Judge Jordan said that the Supreme Court has neither endorsed nor rejected the concept of equitable mootness in chapter 11 cases. He said that every circuit to consider the issue has allowed some formulation of equitable mootness.

The Eleventh Circuit, Judge Jordan said, has applied equitable mootness in chapter 11 and "assumed without deciding that it applies in chapter 7 cases." The appeals court had not addressed the question in chapter 9, however.

Judge Jordan said the "correct result was to join the Sixth Circuit," which had upheld the use of equitable mootness in 2016 in the context of Detroit's municipal bankruptcy. Similarly, the Ninth Circuit Bankruptcy Appellate Panel employed equitable mootness in the Stockton, Calif., debt adjustment in 2015.

Seeing "no reason to reject the doctrine here," Judge Jordan said there was "no respect in which [the] principles [of equitable mootness] are bound to come into play any less in the chapter 9 context than in the contexts of chapters 11 or 13."

Indeed, he said, "these principles will sometimes weigh more heavily in the chapter 9 context precisely because many people will be affected by municipal bankruptcies."

Having decided that equitable mootness applied in chapter 9, Judge Jordan proceeded to rule that it required dismissal of the appeal in Jefferson County's case. He said that the ratepayers never sought a stay pending appeal and had not attempted to expedite the appeal, although those facts in themselves were not determinative.

The appeal had to be dismissed, according to Judge Jordan, because "the County and others have taken significant and largely irreversible steps in reliance on the unstayed plan." Even if the appellate court only struck the bankruptcy court's continuing jurisdiction, he said it "would seriously undermine actions taken in reliance on the confirmation order."

To bolster his conclusion, Judge Jordan "briefly" looked at the merits and saw no injustice in allowing the county to bind elected officials decades into the future. He noted how elected officials "can bind their successors . . . to all kinds of unavoidably long-lasting financial effects, sometimes irreversibly."

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Required records and authenticated documents already known to exist are not protected from production by the privilege against self-incrimination.

Fifth Amendment Can Be an Almost Complete Bar to a Rule 2004 Production

If a witness in a Rule 2004 examination is under criminal investigation, the Fifth Amendment privilege ordinarily protects the witness from being compelled to produce most documents other than tax returns, according to an encyclopedic opinion by Bankruptcy Judge Ronald B. King of San Antonio.

The witness was a former executive of a company in chapter 11. According to Judge King, he had “significant involvement in and control over the debtor’s accounting functions.” The debtor had scheduled a claim against him in an unknown amount for fraud and breach of fiduciary duty.

In an examination under Rule 2004, the debtor’s counsel sought testimony and production of documents “detailed” in what Judge King said were “forty-two expansively written paragraphs.”

The witness said he was the subject of a criminal investigation and was represented at his Rule 2004 examination by both bankruptcy and criminal counsel. He answered questions asking for his name and address. Asserting the Fifth Amendment privilege against self-incrimination, he refused to produce any documents and declined to answer virtually all other questions.

The debtor filed a motion to compel production of documents. In an opinion on August 24, Judge King mostly denied the motion, absolving the witness from the duty to produce documents such as communications and records related to his bank accounts. Judge King only required the witness to produce his tax returns and W-2s under the so-called required documents doctrine.

Judge King traced the history of the privilege, going back to an 1807 opinion by Chief Justice John Marshall. Judge King said that a witness may invoke the privilege “when he or she believes the testimony may travel down the road of possible self-incrimination.” Asserting the privilege comes with a price, he said, because a civil court may draw a negative inference but is not required to do so.

Judge King explained that the privilege "explicitly" extends to protection from production of documents "if the production itself would have testimonial aspects that could be self-incriminating." He paraphrased the Supreme Court as holding "that the act of production itself may implicitly communicate statements of fact, such as the existence of documents, the defendant's possession and control of the documents, and the documents' authenticity."

According to the Supreme Court, "it is not necessary for the documents to be incriminating," Judge King said. Instead, it is "essential" for the witness "to believe (and be able to demonstrate *in camera*, if necessary) that there is a 'real and substantial risk' that the information may tend to incriminate or lead to incrimination."

Judge King laid out the two primary exceptions to the privilege: the foregone conclusion doctrine and the required records doctrine.

Although not pertinent to the case at hand, the foregone conclusion doctrine requires production of documents when control and authenticity of the documents are not at issue and the witness is only being asked to surrender the documents.

With regard to the required records doctrine, Judge King said that the Fifth Circuit and three other circuits have required production of foreign bank account records that the witness was required to keep under Treasury Department regulations. "It follows," Judge King said, that the privilege relieves the witness from producing "records *not* required by law to be kept or disclosed to a public agency." [Emphasis in original.]

Judge King said, however, that neither the foregone conclusion doctrine nor the required records doctrine requires the production of "business records that proprietors might be generally assumed to keep." To compel production, he said, the "documents must be either previously known about and have no issue of authenticity (foregoing conclusion), or required by law to be kept or disclosed to a public agency (required records)."

Judge King said that the case at bar mirrored *U.S. v. Doe*, 465 U.S. 605 (1984), where the defendant had been required to produce personal tax returns. He therefore compelled the witness to produce his personal tax returns for the prior four years and forms W-2. Without examining the documents *in camera*, he absolved the witness from producing "his communications, bank account balances and information, or alleged written admissions of guilt."

Opinion Link

Fourth Circuit disposes of a high-stakes appeal without oral argument in a terse, per curiam opinion incorporating the 'reasons stated by the district court.'

Fourth Circuit Is Strict on 'Person Aggrieved' and Equitable Mootness

In a *per curiam* opinion, the Fourth Circuit rigorously enforced the requirement that an appellant have a pecuniary interest in the outcome of an appeal to avoid dismissal for lack of standing, even if the appeal purports to uphold the integrity of the bankruptcy system.

By adopting the opinion of the district court, the Richmond-based appeals court also ruled that the doctrine of equitable mootness bars an appeal from third-party releases in a consummated chapter 11 plan.

The appeal in the reorganization of coal producer Alpha Natural Resources Inc. centered around a largely two-party dispute involving the debtor's outside financial advisory firm. One of the creditors, a competitor of the financial advisor, persistently challenged the adequacy of the advisor's disclosure of its connections with the debtor and other creditors as required by Bankruptcy Rule 2014.

After months of wrangling, the bankruptcy court ruled in a series of orders that the advisor's disclosures were adequate and that the firm was disinterested. However, the bankruptcy court only required the advisor to file an *in camera* disclosure of the names of some of the advisor's clients. The creditor appealed, challenging the sufficiency of the disclosure and seeking to have the identity of the advisor's clients disclosed publicly.

Over the creditor's limited objection, the bankruptcy court confirmed the debtor's chapter 11 plan containing typically broad releases in favor of nondebtor third parties, including the advisor. The releases barred all manner of claims short of gross negligence and willful misconduct. The creditor took a limited appeal from the confirmation order, in substance asking the district court to set aside the releases in favor of the advisor.

District Judge M. Hannah Lauck of Richmond, Va., dismissed the appeals on Sept. 30, 2017, but the creditor appealed to the Fourth Circuit.

Judge Lauck's opinion takes on greater significance because the Fourth Circuit filed a one-paragraph, nonprecedential, *per curiam* opinion on Sept. 6 affirming dismissal of the appeals "for the reasons stated by the district court." The appeals court also dispensed with oral argument.

Contending that the creditor lacked a pecuniary interest in the outcome of the appeal, the debtor had moved to dismiss the appeal from the bankruptcy court's rulings on the adequacy of the disclosures under Rule 2014. Conceding that further disclosures would put no more money in its pocket, the creditor argued that the appeal was central to the integrity of the bankruptcy system.

In her opinion last year, Judge Lauck dismissed the appeal from the Rule 2014 orders. Even if the financial advisor were later required to disgorge all fees that it had been paid, the creditor would not benefit monetarily because additional cash coming into the estate was earmarked for senior secured lenders. The recovery by unsecured creditors was fixed in the plan.

Even if the appeal led to a monetary recovery from the financial advisor, Judge Lauck said that the creditor was "not a 'person aggrieved' by the Bankruptcy Court's order, and it therefore lacks standing to appeal those rulings."

The debtor likewise moved to dismiss the appeal from confirmation, contending that the case was equitably moot. The creditor argued that the releases in favor of the financial advisor could be carved out without upsetting the overall plan.

Judge Lauck disagreed and dismissed the confirmation appeal on the ground of equitable mootness.

Based on the findings of the bankruptcy court in the confirmation order, Judge Lauck said that the "core transaction [in the plan] was conditioned in part on the releases and exculpation provisions applying to all involved professionals." Quoting the bankruptcy court, she said that excising the releases in favor of the financial advisor would risk "unraveling the 'web of interrelated settlements that had been painstakingly woven together.'" This factor, she said, "also weighs in favor of finding that the . . . appeal is equitably moot."

Opinion Link

Illinois judges disagree on whether direct payments to a mortgagee are "under the plan" and must be made in full to obtain a chapter 13 discharge.

Judges Split on Denial of Chapter 13 Discharge for Missing Direct Mortgage Payments

Bankruptcy judges in Illinois disagree on whether a chapter 13 debtor who fails to make all direct payments on a home mortgage is eligible for a discharge.

Adopting the minority approach, Bankruptcy Judge Thomas L. Perkins of Peoria, Ill., ruled in March that failure to make direct payments on a nondischargeable mortgage is not grounds for denying a chapter 13 discharge. To read ABI's discussion of Judge Perkins' opinion, *In re Gibson*, 582 B.R. 15 (Bankr. C.D. Ill. March 5, 2018), click here.

Chief Bankruptcy Judge Laura K. Grandy of East St. Louis, Ill., confronted a similar case where the confirmed chapter 13 plan called for the debtors to make direct payments to the home mortgage lender going forward. Payments through the trustee cured arrears.

At the end of the plan, the trustee filed a notice saying that the arrears had been cured and that the debtors had made all payments required to be made to the trustee. The debtors filed a motion for entry of discharge, stating they had made all payments required by the plan.

Fifteen days before the deadline for objecting to discharge, the mortgage lender filed a response to the trustee's notice stating that the mortgage was in arrears by almost $71,000. The lender did not object to the entry of discharge, perhaps because the mortgage debt would not be discharged in any event under Sections 1322(b)(5) and 1328(a)(1).

Neither the chapter 13 trustee nor any creditor objected, so Judge Grandy entered the debtor's discharge under Section 1328(a).

One month after the entry of discharge, the chapter 13 trustee filed a complaint to revoke discharge under Section 1328(e), alleging that the debtors had obtained their discharges by fraud. The debtors' counsel argued that the motion for a discharge was accurate because direct payments allegedly were not "under the plan."

Judge Grandy said in her August 28 opinion that she “respectfully” disagrees with Judge Perkins because she believes that direct payments to a mortgagee are “payments under the plan,” as required by Section 1328(a). Direct payments are “under the plan,” she said, because they “must be addressed in that plan.”

However, Judge Grandy did not revoke the debtors’ discharges. Because the lender’s response told the chapter 13 trustee in advance of discharge that the debtors had not made all payments, she allowed the discharge to stand under Section 1328(e) because the trustee knew about the alleged fraud before discharge.

Given the trustee’s tardy objection to discharge, Judge Grandy said it was unnecessary to decide “whether or not the debtors’ statement that they completed all plan payments was fraudulent.”

She ended her opinion with an admonition, saying it was “entirely possible that such statements may rise to the level of fraud.” Therefore, she said, debtors “are advised to carefully consider the accuracy and truthfulness of statements made in their motions for discharge.”

Opinion Link

Ninth Circuit BAP explains when the holder of a nondischargeable claim can be enjoined from collecting during the life of an individual's chapter 11 plan.

Collection Injunctions Are (Sometimes) Ok in an Individual Chapter 11

In an opinion that was not precedential but should have been, the Ninth Circuit Bankruptcy Appellate Panel began laying out the standards for deciding when an individual's chapter 11 plan may permissibly preclude enforcement of a nondischargeable claim during the life of the plan.

In 2003, the West Coast BAP ruled in a case where an individual's chapter 11 plan paid a nondischargeable claim in full over the life of the plan but enjoined the creditor from otherwise enforcing the nondischargeable judgment as long as the debtor was not in default. The BAP upheld confirmation, ruling that there is no *per se* rule prohibiting a collection injunction. *Computer Task Group Inc. v. Brotby (In re Brotby)*, 303 B.R. 177 (B.A.P. 9th Cir. 2003).

In the new case decided by the BAP on July 31, the debtor was saddled with a $2.2 million nondischargeable judgment. The plan precluded the creditor from enforcing the judgment during the five-year life of the plan. The creditor would have been paid about 6% to 9% of the claim over the life of the plan.

Over the creditor's objection, the bankruptcy court confirmed the plan. The creditor with the nondischargeable claim appealed successfully to the BAP.

In the *per curiam* opinion, the BAP said that the principal amount of the nondischargeable debt would actually grow during the pendency of the plan from the accrual of interest on the judgment. The panel reversed confirmation because there was "no provision for any meaningful payment" of the nondischargeable debt. In substance, the panel said the plan "essentially neuters [the creditor's] right to be paid, and thus does not meet the good faith requirement."

Taking up where *Brotby* left off, the panel said that Section 1142(d)(2), precluding discharge of a nondischargeable debt in an individual's chapter 11 case, "does not prohibit a plan from placing conditions on the creditor's right to collect such a claim."

Otherwise, *Brotby* said, the holder of a nondischargeable claim would hold “a veto over the reorganization process.” *Id*. at 189-190.

The panel went on to say that the court may confirm “a plan that merely delays, but does not imperil, the payment of a nondischargeable claim.” To determine if the plan is confirmable, the BAP called for invoking “a simple application of the injunctive relief standards” by determining “the likelihood of ultimate payment (feasibility), as well as balanc[ing] relative hardships.”

In the case on appeal, the panel said that delay, “which is effectively denial of payment, is not outweighed by any benefit to” to the creditor.

The panel was careful to say that the BAP was not laying down a *per se* rule requiring payment of a nondischargeable debt in full over the life of the plan, because the case “simply does not provide us with the opportunity nor the analytical framework to make such a declaration.”

Opinion Link

Judge Lynch of Tacoma follows Idaho's Judge Pappas in determining the size of a 'household' when someone is a part-time resident.

There Are No Fractions of a Household in Tacoma, Washington

The courts are all over the map when it comes to arriving at the size of a "household," a critical factor in deciding whether an individual debtor is subject to the means test and whether a chapter 13 plan will endure for three or five years.

Chief Bankruptcy Judge Brian D. Lynch of Tacoma, Wash., was ruling on the confirmation of a chapter 13 plan for a man who said there were four in his household. The debtor counted himself and his two sons who lived with him full time, plus his daughter who lived in his home on alternate weekends and holidays. The debtor paid child support and medical insurance for his daughter.

The chapter 13 trustee objected to confirmation, contending that the household size was three, not four. If the trustee were correct, the debtor would have been subject to the means test as an above-median income debtor, and his plan would have had a five-year duration, not three.

In his August 10 opinion, Judge Lynch said that "household" is not defined in the Bankruptcy Code. Courts, he said, have taken at least three different approaches, even within the Ninth Circuit.

Some adopt the Census Bureau's "heads on the beds" approach and count everyone in the house, regardless of the economic relationship. Others follow the Internal Revenue Service's definition of "dependent," and a third group follows the "economic unit" approach by evaluating the "financial relationships between the people residing in the debtor's house," Judge Lynch said.

Someone who is financially dependent on the debtor or whose expenses are intermingled with the debtor's will be part of the economic unit, he said.

Judge Lynch concluded that the "economic unit" approach is "the most realistic," following a 2012 opinion by Bankruptcy Judge Jim D. Pappas of Idaho, who focused

on the person's financial dependence on and residence with the debtor. *In re Kops*, 2012 WL 438623, 2012 BL 37703 (Bankr. D. Idaho Feb. 9, 2012).

Judge Lynch said there was "an additional layer" of difficulty because the daughter only lived with the debtor part time. In that situation, he said, courts take "different approaches to counting part-time household members."

According to Judge Lynch, some courts divide a part-time resident into fractions based on the number of days the person resides with the debtor. Other courts, he said, fully count part-timers, as did Judge Pappas in *Kops*.

Like Judge Pappas, Judge Lynch said that Congress adopted "a means test that relies on uniform standards," choosing to "'tolerate the occasional peculiarity that a brighter-line test produces,'" again quoting Judge Pappas. Judge Lynch said that an "occasional peculiarity [is] less concerning than the alternative – getting into the weeds of trying to [make] the fractional household member determinations."

Judge Lynch decided that the daughter was part of the debtor's economic unit. He confirmed the plan because she was his "financial dependent" and resided "with him more than a *de minimis* portion of each month."

Fifth Circuit notches a victory for chapter 13 debtors retaining mobile homes.

Valuation of a Retained Mobile Home Does Not Include Delivery and Setup Costs

The costs of delivering and setting up a mobile home to be retained by a debtor under a chapter 13 plan "must be excluded from the mobile home's valuation under Section 506(a) of the Bankruptcy Code," according to the Fifth Circuit.

The chapter 13 plan promised to pay the secured value of the mobile home over the life of the plan plus 5% interest. To determine value for cramdown under Sections 1325 and 506(a), the lender argued that the bankruptcy court should include $4,000 in costs that would be incurred in delivering the house to the site, along with expenses in blocking, leveling and anchoring the house as required by state law.

Relying on the Supreme Court's decision in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), the bankruptcy court overruled the lender's objection to confirmation and held that the valuation should not include delivery and setup costs. The district court affirmed, prompting the lender to appeal a second time.

In her opinion on August 13, Circuit Judge Jennifer Walker Elrod upheld the lower courts. The debtor did not submit a brief, but the U.S. Trustee supported the bankruptcy judge's decision.

The case was governed by Section 506(a)(1) and (a)(2). The former provides that a secured claim is allowed "to the extent of the value of such creditor's interest in the estate's interest in such property." It goes on to say that such "value shall be determined based on the purpose of such valuation and of the proposed disposition or use of such property."

Subsection (a)(2), added by the BAPCPA amendments in 2005, provides that the value of personal property "shall be determined based on the replacement value of such property . . . without deduction for costs of sale or marketing."

Quoting *Rash*, Judge Elrod said that the "'proposed disposition or use' of the collateral is of paramount importance." *Id.* at 962. Rejecting an argument proffered by the lender, she held that subsection (a)(2) "should not be construed to the exclusion of" subsection (a)(1).

Judge Elrod also attached significance to footnote 6 in *Rash*, where Justice Ginsburg said,•"A•creditor•should•not•receive•portions•of•the•retail•price,•if•any,•that•reflect•the• value of *items the debtor does not receive* when he retains his vehicle, items such as warranties, inventory storage, and reconditioning." *Id.* at 965. [Emphasis added.] Judge Elrod also said that the later addition of subsection (a)(2) in the BAPCPA amendments "does not conflict with *Rash*."

Weaving the principles together, especially the idea that setup and delivery costs were not services the debtor would receive, Judge Elrod held that "delivery and setup costs of a mobile home retained by a debtor must be excluded from the mobile home's valuation under Section 506(a)." She said the U.S. Trustee correctly argued that delivery and setup costs are not costs of sales or marketing but, instead, are additional costs like sales taxes and service agreements.

Judge Elrod said her holding "accords with the determination of all courts that have addressed the issue." The lender could cite "no caselaw to the contrary," she said.

Opinion Link

Host

William J. Rochelle, III is ABI's Editor-at-Large and resides in New York. Previously, he published for Bloomberg from 2007-15. Prior to his second career in journalism, Mr. Rochelle practiced bankruptcy law for 35 years, including 17 years as a partner in the New York office of Fulbright & Jaworski LLP. In addition to writing, he travels the country for ABI, speaking to bar groups and professional organizations on hot topics in the turnaround community and trends in consumer bankruptcies. Mr. Rochelle earned his undergraduate and law degrees from Columbia University, where he was a Harlan Fiske Stone Scholar.

Guests

Hon. Kevin J. Carey is a U.S. Bankruptcy Judge for the District of Delaware in Wilmington, first appointed in 2005 and serving as Chief Judge from 2008-11. He previously served as a U.S. bankruptcy judge for the Eastern District of Pennsylvania, appointed on Jan. 25, 2001. Judge Carey serves on ABI's Executive Committee as Vice President-Membership and is a past global chairman of the Turnaround Management Association. He is a member of the National Conference of Bankruptcy Judges and also serves as an associate editor for the *American Bankruptcy Law Journal*. Judge Carey is the Third Circuit representative on the Administrative Office's Bankruptcy Judges Advisory Group and is a member of the Third Circuit Judicial Council's Facilities and Security Committee. He is also a contributing author to *Collier on Bankruptcy* and *Collier Forms Manual*. Judge Carey is a part-time adjunct professor in the LL.M. in Bankruptcy program at St. John's University School of Law in New York and at Temple University's Beasley School of Law in Philadelphia. He began his legal career in 1979 as law clerk to Bankruptcy Judge Thomas M. Twardowski, then clerked for the U.S. Bankruptcy Court for the Eastern District of Pennsylvania. Judge Carey received his B.A. in 1976 from Pennsylvania State University and his J.D. in 1979 from Villanova University School of Law.

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