JENNER&BLOCK

Recent Developments in Bankruptcy Law, July 2020

(Covering cases reported through 612 B.R. 750 and 961 F.3d 1074)

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1. AUTOMATIC STAY

1.1 Covered Activities

1.2 Effect of Stay

1.3 Remedies

2. AVOIDING POWERS

2.1 Fraudulent Transfers

2.1.a **Bank account deposit is not a "transfer" for UFTA purposes.** The receivership debtors ran a Ponzi scheme. Acting under the state Uniform Fraudulent Transfer Act, the receiver sued the debtors' bank to avoid bank deposits as transfers made with actual intent to hinder, delay, or defraud creditors. The UFTA defines "transfer" as any mode, direct or indirect, of disposing of or parting with an interest in property. Although a deposit to a bank account transfers title to the money to the bank, it remains subject to an unfettered right of withdrawal and is tantamount to cash. The depositor never relinquishes its interest in or control over the funds. Accordingly, the deposit is not a transfer for purposes of the UFTA. *Isaiah v. JPMorgan Chase Bank, N.A.*, 960 F.3d 1296 (11th Cir. 2020).

2.1.b **CEO's intent may be imputed to corporation to prove actual fraudulent transfer.** In financial distress, the debtor agreed with its banks to a substantial paydown of the loans, restructuring of the credit facility and of the company, and release of all claims against the banks. The CEO drove the process, which was ultimately approved by the board, for his own personal gain. He knew or should have known that the transactions would render the company insolvent, unable to recover, and unable to pay its other creditors. After the debtor filed chapter 11, the trustee sued the banks to avoid and recover the paydowns and avoid the releases. The trustee may avoid a transfer made with actual intent to hinder, delay, or defraud creditors. A transferor that believes, appreciates, or knows the natural consequences of the transfer will hinder or delay or defraud creditors has the requisite actual intent. A corporate officer is an agent of the corporation. An agent's intent may be imputed to his principal if the agent's act falls within the scope of the agent's employment or their corporate authority. Imputation may occur even if the agent is not in a position to control the transferor; rather, traditional rules of agency law apply. Here, the CEO acted within his authority in negotiating the transactions, so his intent may be imputed to the debtor, and because he appreciated the consequences of the transaction on other creditors, his intent met the requirements of an actual fraudulent transfer. *Sher v. JPMorgan Chase Funding (In re Thornburg Mortgage, Inc.)*, 610 B.R. 807 (Bankr. D. Md. 2019).

2.2 Preferences

2.3 Postpetition Transfers

2.4 Setoff

2.5 Statutory Liens

2.6 Strong-arm Power

2.7 Recovery

2.7.a **Trustee may not recover proceeds of fraudulently transferred property from a subsequent transferee.** The debtor contracted with an investor to develop wind power projects. The contract required the investor, upon commercial operation, to pay 75% of the projects' purchase price to the debtor and 25% to an advisor. The debtor transferred the development contract to an affiliate without consideration. It later filed bankruptcy. After litigating with the investor, the transferee collected the payments and paid a portion of the cash to two law firms. The trustee avoided the transfer to the affiliate then sought to recover from the law firms as subsequent transferees. Section 550(a) permits the trustee to recover fraudulently transferred property or its value from “the initial transferee of such transfer” or from “any immediate or mediate transferee of such initial transferee,” except one who takes for value, in good faith, and without knowledge of the voidability of the transfer. In this case, the fraudulently transferred property was the contract. Although the law firms received proceeds of that property, neither firm was a transferee of the contract. Section 550 does not provide for recovery of proceeds, and section 541(a)(6)’s inclusion of proceeds in property of the estate does not apply to section 550. Section 550 permits recovery of the value of the property transferred, but only from “the initial transferee of such transfer” or any subsequent transferee. The law firms were neither. Therefore, the trustee may not recover from the law firms. *Rajala v. Spencer Fane LLP (In re Generation Res. Holding Co, LLC),* ___ F.3d ___, 2020 U.S. App. LEXIS 21454 (10th Cir. July 10, 2020).

3. BANKRUPTCY RULES

4. CASE COMMENCEMENT AND ELIGIBILITY

4.1 Eligibility

4.1.a **Personal guarantee of business debts qualifies an individual debtor for SBRA.** The debtors personally guaranteed debts incurred by their wholly-owned corporate businesses. The Small Business Reorganization Act provides special procedures and substantive rules for a small business debtor who elects to proceed under subchapter V of chapter 11. The Act defines an eligible debtor as “a person engaged in commercial or business activities” with less than $7.5 million in debts. The statute does not qualify “engaged in” as limited to currently engaged in business. Here, the majority of the debtors’ debts arose from operation of the current and former businesses. Therefore, they are eligible to proceed under subchapter V. *In re Blanchard*, ___ B.R. ___, Case No. 19-12440 (Bankr. E.D. La. July 16, 2020).

4.2 Involuntary Petitions

4.3 Dismissal

5. CHAPTER 11

5.1 Officers and Administration

5.2 Exclusivity

5.3 Classification

5.4 Disclosure Statement and Voting

5.5 Confirmation, Absolute Priority

6. CLAIMS AND PRIORITIES

6.1 Claims

6.1.a **Landlord damages cap limits claim against bankrupt fraudulent transferee.** The debtor fraudulently transferred assets to his wife. The debtor’s lessor avoided the fraudulent transfer and obtained a judgment against both the debtor and the wife. The lessor’s claim was partially paid under the debtor’s chapter 11 plan, and the debtor received a discharge. The wife later filed her own bankruptcy. Section 502(b)(6) limits a landlord’s claim for damages resulting from a termination of a real property lease, whether the claim is against the tenant or a guarantor.

Similarly, the cap limits the allowable claim against the wife in her bankruptcy, even though the claim arose from the fraudulent transfer judgment, because it still is a claim resulting from breach and termination of the lease. *Lariat Cos., Inc. v. Wigley (In re Wigley)*, 951 F.3d 967 (8th Cir. 2020).

6.1.b **Liquidation safe harbor damage calculation applies to credit enhancements whether or not there is a surplus.** The debtor defaulted on a repo of 28 securities. Under the transaction, the debtor also posted 9 securities as credit enhancement. The counterparty conducted an auction and sold all 37 securities for less than the repo amount. Section 101(47), which defines "repurchase agreement," includes "credit enhancement." Section 559 permits a counterparty, despite the automatic stay, to liquidate, terminate, or accelerate a repo in accordance with its terms, but provides that "any excess of the market prices received on liquidation … shall be deemed property of the estate." Section 562 specifies the means for determining "damages" upon the trustee's rejection or the counterparty's termination of a repo, looking to market data to determine the amount. "Damages" in section 562 means a legal claim for damages, rather than merely a loss, shortfall, or deficiency. Therefore, it applies only if the liquidation of the repo does not result in excess proceeds. Because the counterparty did not initiate a damages action for the shortfall or file a proof of claim, section 562 does not apply in this case. Section 559's exception to the automatic stay applies to the repo, whether or not there are excess proceeds. Otherwise, the counterparty would have to liquidate collateral piecemeal, until it received adequate proceeds to cover the debt, leaving the remaining collateral subject to the automatic stay. Such a process would be contrary to section 559's language, which specifies that excess proceeds "received on liquidation" are property of the estate, and would be impracticable and slow. Therefore, the trustee may not assert a claim against the counterparty for excess proceeds based on a market valuation under section 562, other than the valuation determined by the liquidation and auction. *In re Homebanc Mortg.Corp.*, 945 F.3d 801 (3d Cir. 2019).

6.1.c **Lender does not have an implied liability claim in an ultra vires transaction.** The chapter 9 municipal debtor borrowed from a bank lender, but the loan amount might have exceeded the debtor's borrowing authority. The debtor objected to the bank's claim, arguing the loan was *ultra vires*. Nevertheless, the bank sought recovery on a restitutionery, implied liability basis. *Ultra vires* acts by public entities are void. The law does not imply a liability to pay where a statute prohibits contracting for that liability. *S. Inyo Healthcare Dist. v. Optum Bank, Inc. (In re S. Inyo Healthcare Dist.*, 612 B.R. 750 (Bankr. E.D. Cal. 2020).

6.1.d **Section 502(b)(7) caps earned but unmatured compensation.** The debtor's employee's employment contract provided for a bonus, payable over five years. The contract also provided for a severance payment and the acceleration of any unpaid portion of the bonus if the debtor terminated the employment without cause. The employee earned the bonus before the debtor terminated his employment without cause, but the debtor had paid only a portion. The debtor later filed a chapter 11 petition. The employee sought damages for termination of the employment contract plus interest. Section 502(b)(7) limits an employee's claim for damages resulting from termination of an employment contract to "the compensation provided by such contract, without acceleration, for one year following" termination plus "any unpaid compensation due under such contract, without acceleration," on such date. Although the employee had fully earned the bonus before termination, because the contract extended the payments over time but accelerated them upon termination without cause, section 502(b)(7) limits the employee's allowable claim to the amount provided under the contract for the one year following termination. Section 502(b)(7) similarly limits prepetition interest on the claim. Prepetition interest on the claim's capped portion is limited by the cap; prepetition interest on the uncapped portion, that is, the amount that was already owing on the termination date, is not. *Woods v. 21st Century Oncology Holdings, Inc.(In re 21st Century Oncology Holdings, Inc.)*, ___ F.3d ___, 2020 U.S. App. LEXIS 22473 (2d Cir. July 20, 2020).

6.2 Priorities

6.2.a **Court grants Six Month Rule priority to interline charges.** The railroad debtor owed a railroad creditor for interline charges incurred within a few months before the debtor's chapter 11 case. Section 1171(b) grants priority to claims that would have been entitled to priority in a receivership of the railroad. In a receivership, a creditor would be entitled to priority under the Six Month Rule or under the Necessity of Payment rule. The latter Rule authorizes a receiver to pay obligations he incurs without court authority if the goods or services obtained were necessary to continued rail service. The former Rule reflects equitable considerations so that creditors who supplied goods or services to the railroad shortly before bankruptcy are not disadvantaged compared to those who do so after and receive administrative expense priority. It permits priority to a claim for current operating expenses incurred within six months before bankruptcy for goods or services with the expectation they would be paid from current operating revenues and not in reliance on the railroad's general credit. In this case, the parties specifically contemplated the interline charges would be paid from interline receipts the debtor received, the interline service was necessary for the continued operation of the railroad, and the charges were incurred within a few months before bankruptcy. Therefore, the court grants priority to the charges. *Keach v. New Brunswick S. Ry. Ltd. (In re Montreal Maine & Atl. Ry., Ltd.)*, 953 F.3d 29 (1st Cir. 2020).

7. CRIMES

8. DISCHARGE

8.1 General

8.1.a **Discharge does not release a fraudulent transfer claim against the debtor's transferee.** The debtor fraudulently transferred assets to his wife. The debtor's lessor avoided the fraudulent transfer and obtained a judgment against both the debtor and the wife. The lessor's claim was partially paid under the debtor's chapter 11 plan, and the debtor received a discharge. The wife later filed her own bankruptcy. The landlord filed a claim in her case. Section 502(b)(1) allows a claim except to the extent unenforceable under applicable nonbankruptcy law. A discharge does not extinguish a liability but only provides a defense and an injunction against collection. In addition, a discharge does not release any other entity. Therefore, the fraudulent transfer claim, which was based on the landlord's claim against the husband, was neither satisfied nor extinguished by the husband's discharge, and the landlord's claim against the wife is preserved. *Lariat Cos., Inc. v. Wigley (In re Wigley)*, 951 F.3d 967 (8th Cir. 2020).

8.2 Third-Party Releases

8.2.a **Ninth Circuit approves plan exculpation.** The confirmed plan contained an exculpation provision that released parties closely involved in negotiating, drafting, and confirming the plan from any claims, except claims arising from willful misconduct or gross negligence. Section 524(e) provides that a discharge of a debt does not affect the liability of any other entity on the debt." The Ninth Circuit has construed that section to prohibit third party releases of creditors' claims. However, exculpation does not address creditors' claims against the debtor, which are discharged by a confirmation order. It addresses claims that might arise in the hard-fought, litigious arena of a chapter 11 case and so is not addressed by section 524(e). Therefore, the court affirms the plan confirmation order, which approved the exculpation clause. *Blixseth v. Credit Suisse*, 961 F.3d 1074 (9th Cir. 2020).

8.3 Environmental and Mass Tort Liabilities

9. EXECUTORY CONTRACTS

9.1.a **Unscheduled executory contract is deemed rejected after 60 days.** The chapter 7 individual debtor had a two-year contract for satellite service. In her schedules, she listed an unpaid amount owing to the satellite company but not the contract. An executory contract the trustee does not assume within 60 days after the order for relief is automatically rejected. The rejection is automatic, whether or not the debtor listed the contract as an executory contract on Schedule G, as long as the counterparty is listed as a creditor so the trustee has notice of the relationship, the creditor had notice of the bankruptcy, and the failure to list was not to intentionally conceal the contract. Rejection is a breach of the contract; the resulting damage claim is determined as those it arose immediately before the commencement of the case. A discharge releases the debtor from all debts that arose prepetition or that are determined as if they arose prepetition. Because the debtor listed the satellite company, the trustee had notice of the relationship, the company had notice of the bankruptcy, and the debtor did not intentionally conceal the contract, the contract was deemed rejected after 60 days, and the debtor was discharged from all obligations under the contract. *Medley v. Dish Network, LLC*, 958 F.3d 1063 (11th Cir. 2020).

10. INDIVIDUAL DEBTORS

10.1 Chapter 13

10.2 Dischargeability

10.2.a **Discovery sanctions are dischargeable.** The debtor attorney incurred discovery sanctions, payable to her client's adversary. She refused to pay. The State Bar initiated disciplinary proceedings against her for her failure to obey the court's order that she pay and ultimately suspended her from practice, with reinstatement contingent on payment of the sanctions. Shortly after the state supreme court affirmed the disbarment order, she filed a bankruptcy petition and sought to discharge the sanctions. Section 523(a)(7) makes nondischargeable any debt that is "for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss." These discovery sanctions were payable to a private party—the adversary in the litigation in which they were imposed—not a governmental unit, and they were in compensation for the party's litigation expenses related to the discovery violations. *Kelly v. Robinson*, 479 U.S. 36 (1986), which involved a criminal restitution payment to the government for the benefit of the victim, does not require otherwise. *Kelly* was based on the Court's "deep conviction" and a "background of an established judicial exception," not on the language of section 523(a)(7). The statutory language does not cover these discovery sanctions, which are therefore dischargeable. *Albert-Sheridan v. State Bar (In re Albert-Sheridan)*, 960 F.3d 1188 (9th Cir. 2020).

10.2.b **Penalty to government for fraud on consumers is dischargeable under sections 523(a)(2)(A) and 1141(d)(6).** The debtor defrauded telephone consumers. The FCC required the debtor to refund money to consumers and imposed a civil penalty in favor of the United States, some of which remained unpaid when the debtor filed its chapter 11 case. In an individual case, section 523(a)(2)(A) renders nondischargeable a debt for money, property, or services, to the extent obtained by actual fraud. In a chapter 11 case, section 1141(d)(6) renders nondischargeable such a debt owed to a domestic governmental unit. The discharge exception encompasses exemplary and punitive damages resulting from fraud, not just compensatory damages. However, it covers only debts incurred by actual common law fraud on the creditor. The penalty here is a statutory claim arising from a fraud perpetrated on the consumers, not the government, and not a common law fraud case to recover for the government's own injury. Therefore, the debt is dischargeable. *U.S. v. Fusion Connect, Inc. (In re Fusion Connect, Inc.)*, ___ B.R. ___, 2020 Bankr. LEXIS 1803 (Bankr. S.D.N.Y. July 9, 2020).

10.3 Exemptions

10.4 Reaffirmations and Redemption

11. JURISDICTION AND POWERS OF THE COURT

11.1 Jurisdiction

11.2 Sanctions

11.3 Appeals

11.3.a **Equitable mootness doctrine applies to a liquidating plan.** The debtor confirmed a liquidating plan that subordinated intercompany claims. The subordination resulted in no recovery on those claims. The liquidating trustee for the affiliates objected to and appealed from the confirmation order and sought a stay pending appeal, which the bankruptcy court and the district court denied. The debtor's representative consummated the plan and distributed cash to holders of priority and undisputed unsecured claims. The court may dismiss an appeal from a plan confirmation order as equitably moot if reversal would be inequitable or impracticable. Although the courts consider six factors, the foremost concern is what effects reversal would have on third-party creditors. That analysis does not differ when the plan provides for liquidation rather than reorganization, because by-stander creditors can still be harmed by reversal by the risk of distribution clawback long after they have received and relied on the distributions. In this case, the equitable mootness factors were met. That the plan was a liquidation rather than an operating reorganization does not change that result. *Drivetrain, LLC v. Kozel (Abengoa Bioenergy Biomass of Ks., LLC)*, 958 F.3d 949 (10th Cir. 2020).

11.4 Sovereign Immunity

12. PROPERTY OF THE ESTATE

12.1 Property of the Estate

12.2 Turnover

12.3 Sales

13. TRUSTEES, COMMITTEES, AND PROFESSIONALS

13.1 Trustees

13.1.a **Trustee's compensation is based only on disbursements in the case, not in any related case.** The chapter 7 trustee became the managing member of the debtor's 100%-owned LLC, which was a chapter 11 debtor. During the chapter 11 case, the trustee, acting as managing member of the LLC and not as the chapter 11 trustee, sold the LLC's assets and paid a substantial distribution to creditors under a plan, returning a surplus to the chapter 7 estate. The trustee paid claims in the chapter 7 case from the surplus and from other funds on hand. Section 326(a) permits compensation of a trustee, not to exceed certain percentages "upon money disbursed or turned over in the case by the trustee to parties in interest." In the context of the chapter 7 case, "in the case" refers only to the chapter 7 case and not to the moneys disbursed or turned over in the "subsidiary" chapter 11 case. Therefore, the trustee's compensation is based only on the moneys disbursed to creditors of the chapter 7 estate. *Connolly v. Morreale (In re Morreale)*, 959 F.3d 1002 (10th Cir. 2020).

13.1.b **Court did not abuse discretion in refusing to appoint a chapter 9 avoidance trustee.** Section 926 permits the court to appoint a trustee to pursue avoiding power claims if the municipal debtor refuses to pursue them. The decision is committed to the sound discretion of the trial court and will be reversed only for an abuse of discretion. Courts should hesitate to appoint a trustee. In exercising its discretion, the court need not apply the same test as used for derivative standing in a commercial case—evaluating the costs and benefits to the debtor and determining whether the claims are colorable. Because the debtor is a governmental unit, the court may apply a more holistic approach. Therefore, when the trial court refused the creditors' motion for appointment of a trustee to pursue avoiding power claims against an affiliated debtor that adopted a statute before bankruptcy to transfer funds from the debtor to the affiliate, the court did not abuse its discretion. *Andalusian Global Designated Activity Co. v. The Fin. Oversight and Mgmt. Bd. for Puerto Rico (In re The Fin. Oversight and Mgmt. Bd. For Puerto Rico)*, 954 F.2d 1 (1st Cir. 2020).

13.2 Attorneys

13.3 Committees

13.4 Other Professionals

13.5 United States Trustee

14. TAXES

14.1.a **Straddle year corporate income taxes are entitled to administrative expense priority.** The debtor sold all its property before filing its bankruptcy petition, which it filed on October 15. Its regular tax reporting year ended on December 31. Section 503(b)(1)(B) grants administrative expense priority to "any tax incurred by the estate … except a tax of a kind specified in section 507(a)(8)." An income tax of a kind specified in section 507(a)(8) is one for which the return is due prepetition. The return for the straddle year was due postpetition, after the close of the tax year. A tax is "incurred." When it accrues and becomes a fixed liability. Applicable tax law determines when that occurs. For federal income taxes, the tax accrues and becomes fixed at the close of the tax year. Therefore, the tax was incurred by the estate, not by the prepetition debtor, and is entitled to administrative expense priority. *U.S. v. Beskrone (In re Affirmative Inc. Holdings Inc.)*, ___ B.R. ___, case no. 19-2034-RGA (D. Del. July 27, 2020).

15. CHAPTER 15—CROSS-BORDER INSOLVENCIES