JENNER&BLOCK

Recent Developments in Bankruptcy Law, January 2016

(Covering cases reported through 541 B.R. 768 and 804 F.3d 977)

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1. AUTOMATIC STAY

1.1 Covered Activities

1.1.a **Prejudgment asset freeze order on SEC's motion does not violate the automatic stay.** In an SEC action for securities law violations, the district court found the debtor liable and ordered disgorgement. The SEC moved for an order temporarily freezing the debtor's assets. While the motion was pending, the debtor filed a chapter 11 petition. The district court proceeded with the hearing on the motion and issued a freeze order for the debtor's assets, with an eye toward "working harmoniously and cooperatively with the bankruptcy court" and therefore limited the freeze until the assets are "scheduled and thereby are clearly under the control of the Bankruptcy Court." The automatic stay prohibits any act to obtain possession or control of property of the debtor or of the estate, but it excepts a governmental unit's action to enforce its police or regulatory power, except to enforce a money judgment. The court issued the freeze order before it entered judgment, so the freeze was not part of a judgment enforcement proceeding. The order did not transfer title or possession of the assets but simply preserved the status quo. And the order does not impair the automatic stay's general purpose of centralizing in the bankruptcy court all dipsutes concerning property of the estate or the exception's purpose of preventing a debtor from frustrating governmental functions by filing bankruptcy. Therefore, the asset freeze order was within the police or regulatory exception but not within the exception to the exception for money judgment enforcement. *SEC v. Miller*, 808 F.3d 623 (2d Cir. 2015).

1.1.b **Imposition of multi-employer pension plan withdrawal liability on the debtor's affiliates does not violate the automatic stay.** The debtor's subsidiaries participated in a multi-employer pension plan. On the same day three creditors filed an involuntary petition against the debtor, the pension plan sent a notice to the subsidiaries that the plan was expelling them from the plan. Three days later, the subsidiaries filed voluntary chapter 11 petitions. One month later, the plan asserted withdrawal liability against the members of the debtor's controlled group that were not debtors in bankruptcy cases. Under ERISA, one employer's withdrawal from a plan imposes withdrawal liability on the employer and all members of its controlled group. For ERISA purposes, all such members are treated as a single employer. The members' withdrawal liability is joint and several. (The case law is divided on whether withdrawal liability is a new obligation or simply the fixing of a date to determine a pre-existing obligation; the court here does not resolve the issue.) The automatic stay prohibits commencement or continuation of an action against the debtor that was or could have been commenced before bankruptcy, any act to obtain possession or exercise control over property of the debtor or the estate, and any act to collect, assess, or recover from the debtor a prepetition claim. The stay does not apply to non-debtors. ERISA's treatment of controlled group members as a single employer does not mean that the imposition of withdrawal liability on the non-debtors imposed it on the debtors, because withdrawal liability is joint and several; its imposition on the nondebtors does not require or necessarily result in imposition on the debtors. Therefore, the plan's actions did not violate the automatic stay. *In re Caesar's Entertainment Op. Co., Inc.*, 540 B.R. 637 (Bankr. N.D. Ill. 2015).

1.2 Effect of Stay

1.3 Remedies

1.3.a **Debtor-appellee may recover attorneys' fees for creditor's appeal of order enforcing the stay.** A mortgage servicer foreclosed in violation of the automatic stay. The debtor filed a motion seeking reversal of the servicer's actions and imposition of damages, including attorneys' fees incurred in the stay enforcement motion, which the bankruptcy court granted. The servicer appealed to the district court, which affirmed. The debtor sought attorneys' fees for the district court appeal. Section 362(k)(1) provides, "an individual injured by any willful violation of a stay … shall recover actual damages, including costs and attorneys' fees." The provision does not limit the remedy to damages alone or to damages, including fees, incurred in ending the stay violation. It also encompasses fees incurred in prosecuting a damages action. A statute authorizing an attorneys' fees award at trial ordinarily includes fees incurred in defending the judgment on appeal. Therefore, the debtor may recover attorneys' fees for the appeal. *America's Servicing Co. v. Schwartz-Tallard (In re Schwartz-Tallard)*, 803 F.3d 1095 (9th Cir. 2015), *overruling Sternberg v. Johnson*, 595 F.3d 937 (9th Cir. 2010).

2. AVOIDING POWERS

2.1 Fraudulent Transfers

2.1.a **Actual intent to hinder, delay or defraud requires allegations that the debtor intended that result, not merely that the result was the natural consequences of the debtor's actions.** The debtor failed from LBO debt. Under its chapter 11 plan, creditors assigned to a creditors' trust their fraudulent transfer claims against the shareholders who received the LBO consideration. The trustee's complaint alleged that the directors knew the projections that supported the LBO debt were grossly inflated, knew that the increased leverage posed substantial risks to the debtor in light of the cyclicality of the debtor's business, knew that the financing would leave the debtor undercapitalized, knew they were thereby putting creditors at grave risk and therefore knew that the LBO would hinder, delay or defraud creditors. A creditor may avoid a transfer that the debtor makes with actual intent to hinder, delay or defraud creditors. Under Fed. R. Civ. Proc. 9(b), the plaintiff must plead fraud with particularity, alleging facts that give rise to a strong inference of fraud. Allegations that make fraud merely a plausible inference are not adequate. Actual intent to defraud requires that the defendant desired to cause his act's consequences or that he believed that the consequences were substantially certain to result, not merely that the consequences were the foreseeable results or the natural consequences of the act. Moreover, intent to commit other wrongful acts such as negligence, gross negligence, recklessness and breach of fiduciary duty commited do not constitute actual intent to hinder, delay or defraud creditors. Here, the complaint alleges actual intent only formulaically and only by saying the directors knew the LBO would hinder, delay or defraud creditors, without saying how they knew or whether they intended that result. Therefore, the court dismisses the complaint for failure to state a claim. *Weisfelner v. Fund 1 (In re Lyondell Chemical Co.)*, 541 B.R. 172 (Bankr. S.D.N.Y. 2015).

2.2 Preferences

2.2.a **Payment to new supplier may qualify for ordinary course of business defense.** The debtor mined coal by the "continuous mining" process. It concluded that it could increase production by switching to the "long wall" process. It ordered long-wall mining equipment from a supplier with whom it had never previously done business, agreeing to pay the supplier in installments as the equipment was produced, installed, and tested. It paid an invoice two days before its due date but within 90 days before creditors filed an involuntary petition against it. A trustee may avoid and recover a payment to a creditor on account of an antecedent debt, made while the debtor was insolvent within 90 days before bankruptcy, unless the creditor can show that the debt was incurred and the payment was made in the ordinary course of business of the debtor and creditor. Because the preference exception applies to payments made in the ordinary course of business *of* the debtor and the creditor, not the ordinary course *between* the debtor and the creditor, a payment in connection with a new business relationship qualifies for the exception. The test looks at the parties' ordinary course of business in general, not solely the course of business between them. Here, the debtor incurred the debt in operating and trying to improve its business and in the supplier's ordinary course of providing mining equipment to mining companies. The debtor paid the invoice according to its terms, which is in the ordinary course of business. Therefore, the exception applies. *Jubber v. SMC Electrical Prods., Inc. (In re C.W. Mining Co.)*, 798 F.3d 983 (10th Cir. 2015).

2.3 Postpetition Transfers

2.4 Setoff

2.5 Statutory Liens

2.6 Strong-arm Power

2.7 Recovery

2.7.a **"Without knowledge of voidability" applies to the initial, not the subsequent, transfer.** The debtor's principals engaged in a scheme to defraud creditors through a bogus equipment financing business. The principals diverted substantial funds from the debtor and used them to gamble at a casino. The principals gave the casino a false financial statement, which the casino learned about through a credit check. The casino still increased the principals' credit line. In addition, the principals acted erratically at the casino. After bankruptcy, the trustee sought to recover $8 million from the casino as a subsequent transferee of the fraudulent transfers from the debtor to the principals. Section 550(a)(2) permits a trustee to recover from a subsequent transferee to the extent that a transfer is avoided, but section 550(b)(1) gives a defense to a transferee "that takes for value, in good faith, and without knowledge of the voidability of the transfer avoided." Under the statutory scheme, the trustee may avoid only the initial transfer and may only recover the transferred property from a subsequent transferee. Therefore, the "transfer avoided" is the initial transfer, not the subsequent transfer. The court must test the subsequent transferee's knowledge of the initial transfer, not of the subsequent transfer. In this case, the casino might have been suspicious of the principals' behavior, giving rise to inquiry notice, but only of the principals' transfers to the casino, not of the debtor's transfer to the principals. Therefore, the trustee may not recover from the casino. *Brandt v. Horseshoe Hammond, LLC (In re Equip. Acq. Res., Inc.)*, 803 F.3d 835 (7th Cir. 2015).

3. BANKRUPTCY RULES

4. CASE COMMENCEMENT AND ELIGIBILITY

4.1 Eligibility

4.1.a **Assignee for the benefit of creditors may not file a voluntary petition for the debtor.** A Florida debtor made an assignment for the benefit of creditors under the Florida ABC statute. After a dispute arose in the assignment, the assignee filed a voluntary chapter 7 petition for the debtor assignor. State law determines who has authority to file a bankruptcy petition for a corporate debtor. Florida law grants that power to a corporation's board of directors. Though the Florida ABC statute requires the assignor to use the statutory language in the assignment, under which the assignor appoints the assignee "its true and lawful agent, irrevocable, with full power and authoriy to do all acts and things which may be necessary to execute the assignment," that power is limited to carrying out the assignment and does not contemplate authorizing the assignee to commence a bankruptcy as an alternative to the assignment. Therefore, the assignee does not have authority to file the petition. *Ullrich v. Welt (In re NICA Holdings, Inc.)*, ___ F.3d ___, 2015 U.S. App. LEXIS 21991 (11th Cir. Dec. 17, 2015).

4.2 Involuntary Petitions

4.2.a **Court may dismiss an involuntary petition for bad faith.** The debtor and two creditors had been litigating for over five years. The creditors obtained a consent judgment against the debtor for $300,000; the debtor had a pending arbitration against one of the creditors that sought $5 million in damages. The debtor no longer operated and had no cash but hoped an arbitration award would provide funds to pay its 50 creditors over $2 million in debts. After obtaining the consent judgment, the creditor terminated the arbitration; the debtor moved to compel reinstatement. Before the court ruled, the two creditors and one other filed an involuntary petition against the debtor, which satisfied the requirements for an order for relief. Section 303 refers to a "bad faith" involuntary petition filing only in subsection (i), providing for punitive damages, after the court dismisses a petition, against a petitioner who files in bad faith. The reference suggests the court may dismiss an otherwise sound involuntary petition for bad faith, because a reading permitting only damages but not dismissal would not make sense. Bankruptcy is an equitable proceeding, which must be based on good faith. Finally, because a damages award might not cure an involuntary petition's full harm against a debtor, a court should be able to dismiss a petition filed for an improper purpose. A court should determine whether an involuntary petition is filed in bad faith based on the totality of the circumstances, the same as it does for evaluating dismissal of a voluntary petition. Using an involuntary petition as a litigation tactic or to collect a debt ahead of other creditors, contrary to bankruptcy's collective action spirit, or for retribution might constitute bad faith. Here, the creditor's effort to prevent the arbitration, collect his own claim and prevent other creditors from being paid through a potential arbitration award against the creditor constituted bad faith and justified dismissal. *In re Forever Green Athletic Fields, Inc.*, 804 F.3d 328 (3d Cir. 2015).

4.2.b **Creditors' lack of confidence in management is not grounds for appointment of involuntary gap interim trustee.** The involuntary debtor owned real property that it had sought, for over 15 years, to develop as a casino. It had borrowed from several sources but ran short of funds. It had not paid its CEO or its rent for most of the several years before bankruptcy and had defaulted on its borrowed money obligations. Three creditors filed an involuntary petition and an emergency motion for the appointment of an interim trustee, alleging gross mismanagement by failing to pay their notes while continuing to enrich management, actions contrary to creditors' and shareholders' interests, and the lack of development progress. Section 303(g) permits the court to order the appointment of an interim trustee pending a decision on an involuntary petition "if necessary to preserve the property of the estate or to prevent loss to the estate." An order for relief on an involuntary petition is an extreme remedy with serious consequences to the debtor; the appointment of an interim trustee is an even more extreme remedy and should be administered with caution. It requires not only a showing of a need to preserve or prevent loss to property of the estate but also that the granting of an order for relief is likely. In this case, an order for relief is likely. However, the debtor was not an operating company, and there was no evidence that anything different would happen during the gap. The real property was appraised at substantially more than the debtor's debts. And the on-going decline in cash balances resulting from payment of ongoing expenses would likely continue under an interim trustee. The petitioning creditors' lack of confidence in management is not enough to justify the extreme relief of appointment of an interim trustee. Therefore, the court denies the motion. *In re Diamondhead Casino Corp.*, 540 B.R. 499 (Bankr. D. Del. 2015).

4.3 Dismissal

4.3.a **Court dismisses Bahamian debtors' chapter 11 cases under section 305(a) based primarily on parties' expectations of location of insolvency proceedings.** The debtors were formed to own, construct and manage a resort in The Bahamas. One of the debtors was a Delaware LLC; the rest were Bahamian corporations. They contracted with a Chinese construction firm to build the resort and primarily with Chinese lenders to finance the project. New York law governed the construction contracts, and the parties consented to New York jurisdiction and venue to resolve disputes. English law governed the credit agreement, and the parties consented to English jurisdiction and venue. Bahamian law governed the security interests. Construction was delayed, disputes arose, and the debtors ran short of cash. Attempts to negotiate a consensual resolution were unsuccessful. The Bahamian debtors opened bank accounts in New York, and 10 days later, all debtors filed chapter 11 cases in Delaware and promptly filed a petition in the Bahamian Supreme Court for recognition of the Delaware chapter 11 cases and an action against the construction company in London. Three weeks later, the Bahamian Attorney General filed winding up petitions against the Bahamian debtors in the Bahamian Supreme Court. The Bahamian Supreme Court denied the recognition petitions and refused to enforce the chapter 11 automatic stay in The Bahamas, finding that creditors would have expected insolvency proceedings to take place in The Bahamas, not the United States. The Bahamian court appointed provisional liquidators for several of the debtors, "with the power to promote a scheme/plan of compromise between all stakeholders." The Chinese entities moved for dismissal of the chapter 11 cases. Under section 109, the debtors are eligible for chapter 11 if they have property in the United States, which they do, even though it was of recent vintage. A court may dismiss a bad faith filing, but the debtors here filed with a valid purpose to reorganize and not to gain litigation advantage, so the filing was in good faith. Section 305(a) permits the court to dismiss or suspend proceedings if creditors' and the debtor's interests would be better served by dismissal or suspension. The parties likely did not expect that any main insolvency proceeding would take place in the United States, and nothing about the debtors' conduct suggest that a chapter 11 case would facilitate a consensual resolution better than the Bahamian proceeding would. Therefore, the court dismisses the chapter 11 cases, except the case of the Delaware LLC. *In re Northshore Mainland Servs., Inc.*, 537 B.R. 192 (Bankr. D. Del. 2015).

5. CHAPTER 11

5.1 Officers and Adminisration

5.1.a **Beneficiary of a trust that is a creditor does not have party-in-interest standing.** A dispute arose between the reorganized debtor and its principal creditor, which was owned by a trust. A decedent had established the trust for the benefit of his son, who was the sole, non-contingent beneficiary. The creditor, acting through the trust's trustees, settled the dispute, and the debtor in possession sought bankruptcy court approval. Shortly after the debtor in possession filed the approval motion, the state probate court replaced the trustees for malfeasance. The son objected to the settlement, arguing that the trustees had breached their fiduciary duties. The new trustee joined the objection. The bankruptcy court approved the settlement. The son and the new trustee appealed. The district court dismissed the son's appeal for lack of standing but continued to hear the new trustee's appeal while the son appealed to the court of appeals. Section 1109(a) grants a party in interest, including a creditor, equity holder, and certain others, standing to appear and be heard in a chapter 11 case. While "party in interest" is broad, it is not unlimited. It includes only one who has a legally protected interest that could be affected by the chapter 11 case, such as where the bankruptcy court's ruling might directly affect the party's legal interest by determining its liability or its right to recover. It does not include one whose rights are only derivative of a party in interest's rights, such as a trust beneficiary where the trust or its subsidiary is the debtor's creditor. Any dispute between the beneficiary and his trustee should be heard by the appropriate non-bankruptcy court. It is not an issue that the bankruptcy court should or need resolve. Therefore, the son did not have party-in-interest standing to object to the settlement. *Hughes v. Tower Park Props., LLC (In re Tower Park Props., LLC)*, 803 F.3d 450 (9th Cir. 2015).

5.2 Exclusivity

5.3 Classification

5.4 Disclosure Statement and Voting

5.5 Confirmation, Absolute Priority

5.5.a **Court may award postpetition interest to an unimpaired unsecured class in a solvent case under the court's equitable powers.** The debtor had issued unsecured notes that were not guaranteed by its parent corporation. Its parent was also in bankruptcy in a jointly administered case with the debtor. The joint plan provided that the class of note claims was unimpaired and would receive payment in cash in full in an amount equal to the allowed claim plus postpetition interest to the extent the court allowed and for the payment in cash in full of claims against the parent, i.e., the debtor was solvent. The debtor in possession objected to the allowance of claims for postpetition interest. Section 502(b)(2) disallows any claim for postpetition interest. Section 1129(a)(7) requires payment under a plan of an amount at least equal to the amount the claim would receive in a liquidation case; section 726(a)(5) requires payment in a solvent liquidation case of interest at the legal rate, which is the federal judgment rate. But section 1129(a)(7) applies only to an impaired class. Similarly, the fair and equitable rule of section 1129(b) applies only to a nonaccepting impaired class, but in any event, it requires only payment of unsecured claims' allowed amount or that no junior class receive or retain any consideration under the plan. A class is unimpaired under section 1124(1) if the plan does not alter the legal, equitable, or

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contractual rights of the holders of claims in the class. Under former section 1124(3), a class whose claims received full payment in their allowed amounts was not impaired, but Congress deleted that paragraph in 1994 to overrule a case that interpreted it to treat as unimpaired a class whose claims did not receive postpetition interest. Because section 502(b)(2) disallows postpetition interest, a plan that does not provide for payment of postpetition contract rate interest does not alter the holders' legal or contractual rights: the statute, not the plan, alters their rights. However, awarding postpetition interest on an unsecured claim in an unimpaired class is a matter of equity consistent with the Supreme Court's interpretation of the fair and equitable rule. It also resolves the conflict between the interpretation that statutory impairment under section 502(b)(2) does not require payment of postpetition interest for nonimpairment and Congress' deletion of former section 1124(3) to overrule prior case law that a class whose claims received payment of the petition date allowed claim amount in cash in full was not impaired. Therefore, the plan must provide that the court may award postpetition interest an an appropriate rate under its equitable powers. Equity might not require payment of postpetition interest where any surplus resulting from nonpayment of postpetition interest allows payment of the parent's creditors rather than a return to the ultimate equity holders, but the court does not yet have an adequate record to determine what equity requires here. *In re Energy Future Holdings Corp.*, 540 B.R. 109 (Bankr. D. Del. 2015).

6. CLAIMS AND PRIORITIES

6.1 Claims

6.1.a **Trustee may surcharge collateral under section 506(c) even if expenses were not intended to benefit the secured creditor.** The estate's principal asset was real property encumbered by three liens. At the beginning of the case, the trustee believed there to be equity in the property. Accordingly, he expended unencumbered estate assets to protect and preserve the property, including maintenance, insurance, and taxes. However, his attempts to sell the property yielded a price that was less than the amount required to satisfy the first mortgage. The first mortgagee objected to a sale at that price. The trustee then moved to abandon the property to the mortgagee but to surcharge the property for the expenses he had incurred in protecting and preserving the property. Section 506(c) permits a trustee to recover from encumbered property "the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of" the secured claim. The statutory language does not limit the surcharge to expenses incurred with the specific intent to benefit the secured creditor. Actual benefit suffices, to prevent the secured creditor's unjust enrichment at the expense of the estate. However, to qualify, the benefit must be direct and quantifiable and must be primarily to preserve or dispose of the encumbered property, so as not to charge the creditor with general administrative expenses that are properly the responsibility of the general estate. The surcharge may include even expenses incurred while the trustee reasonably but unsuccessfuly attempts to realize value for the estate if they ultimately benefit the secured creditor. *SW Secs., FSB v. Segner (In re Domistyle, Inc.)*, ___ F.3d ___2015 U.S. App. LEXIS 22787 (5th Cir. Dec. 29, 2015).

6.2 Priorities

6.2.a **Chapter 7 creditor may recover for "substantial contribution."** Three creditors successfully pursued a motion to remove the chapter 7 trustee for malfeasance. The successor trustee recovered from the removed trustee, resulting in a substantial recovery for unsecured creditors. Two of the three creditors sought reimbursement of their fees and expenses as an administrative expense. Section 503(b) permits allowance of administrative expenses, "including … (3) the actual, necessary expenses … incurred by (D) a creditor … in making a substantial contribution in a case under chapter 9 or 11 of this title." Equitable principles govern bankruptcy jurisdiction, but the statutory language is the keystone on which all other analysis rests, so a court may not authorize what the Code prohibits. Although section 503(b)(3)(D) authorizes substantial contribution fees in chapter 9 and 11 cases, it does not prohibit their allowance in chapter 7 cases. And the lead-in of section 503(b) uses "including," meaning that the list of allowable administrative expenses is not exclusive. Therefore, the court may allow the creditor's fees and expenses for a substantial contribution in this case. *Mediofactoring v. McDermott (In re Connolly N. Am., LLC)*, 802 F.3d 810 (6th Cir. 2015).

6.2.b **Responsible officer liability for unemployment tax is entitled to tax priority.** The individual debtor's corporation failed to pay state unemployment taxes that accrued within three years before the debtor's filing bankruptcy. State unemployment tax law imposes liability on a corporation's responsible officers for unpaid unemployment taxes. Section 507(a)(8)(C) grants priority to a tax required to be withheld or collected from others; section 507(a)(8)(E) grants priority to excise taxes incurred within three years before bankruptcy. The priorities are not mutually exclusive, so even if the tax is required to be withheld or collected from others, another tax priority provision might also apply. In this case, the unemployment taxes are imposed on the employer, so the "withheld or collected" priority does not apply. The state statute that imposes liability on a responsible officer does not convert the liability into something other than a tax. Therefore, the responsible officer liability retains its character as a tax and is entitled to the same priority in the responsible officer's bankruptcy case that it would have had in the corporation's bankruptcy case. *Carpenter v. Montana Dept. of Labor (In re Carpenter)*, 540 B.R. 691 (9th Cir. B.A.P. 2015).

6.2.c **Court subordinates co-underwriters' contribution claim for underwriting debtor's affiliate's securities.** A broker-dealer underwrote its parent's debt security issuances under an underwriting agreement with co-underwriters that provided for contribution among them for damages arising from the underwriting. After the parent's chapter 11 filing and the broker-dealer's SIPA proceeding, securities purchasers sued the co-underwriters for damages. The co-underwriters asserted claims for contribution against the broker-dealer. Section 510(b) subordinates "a claim …for reimbursement or contribution … on account of" a "claim for damages arising from the purchase or sale of" a "security of the debtor or of an affiliate of the debtor." The courts give section 510(b) a broad reading. The parent is an affiliate, and the co-underwriters seek a claim for contribution arising from securities purchasers' claims for damages arising from the purchase of the parent's securities. Therefore, the claim falls squarely within the statutory language and should be subordinated. Section 510(b) requires subordination "to all claims or interests that are senior to or equal to the claim or interest represented by such security." There are no "claims represented by [the parent's] security" in the broker-dealer's SIPA proceeding. So to effect the subordination, the bankruptcy court must determine an appropriate level. Where, as here, the security represented a general unsecured claim against the parent, the bankruptcy court appropriately subordinates the claim to general unsecured claims against the broker-dealer. *ANZ Secs., Inc. v. Giddens (In re Lehman Brothers Inc.)*, ___ F.3d ___, 2015 U.S. App. LEXIS 21606 (2d Cir. Dec. 14, 2015).

6.2.d **Court may not equitably subordinate a claim based on the creditor's negligence or failure to act on inquiry notice.** The debtor was required by commodity trading regulations to keep customer property segregated from its own assets. Despite this requirement, it used customer-segregated assets to secure its obligations arising from its own proprietary trading activities. Financial reverses prevented the debtor from covering all of its loans to the bank and therefore restoring customer funds to the segregated accounts. Instead, the debtor took more customer assets out of segregation to secure the bank loans in an apparently sincere, but ultimately hopeless and desperate, attempt to prevent collapse. The trustee successfully avoided the bank's lien on the customer assets under section 548(a)(1)(A), because the debtor intended to hinder, delay, or defraud its customers by using their assets to secure its own obligations, and the bank was on inquiry notice of the debtor's fraud on its customers and so did not have a "good faith" defense under section 548(c). The trustee sought to subordinate the bank's now unsecured claim under section 510(c), which permits subordination based on principles of equitable subordination. Equitable subordination is a draconian remedy based on conduct that harms creditors and that is not only inequitable but also egregious, tantamount to fraud, or willful. Here, the bank's conduct clearly harmed the debtor's customers, who were left with unpaid claims. But in the absence of a showing that the bank actually knew, rather than merely suspected, the debtor's fraud, the bank was not itself engaged in fraud on the debtor or its customers. Equitable subordination requires conduct that is more than negligence for failing to investigate based on inquiry notice. Therefore, the court denies the trustee's request for equitable subordination. *Grede v. Bank of N.Y. Mellon Corp. (In re Sentinel Mgmt. Group, Inc.)*, ___ F.3d ___2016 U.S. App. LEXIS 284 (7th Cir. Jan. 8, 2016).

7. CRIMES

8. DISCHARGE

8.1 General

8.1.a **Discharge does not affect liquidating trust's liability for post-effective date action against prepetition contract counterparty.** The debtor purchased mortgages under a correspondent client agreement that granted attorneys' fees to the prevailing party in any legal action between the debtor and the seller. The debtor confirmed a chapter 11 plan that rejected the agreement, preserved the successor liquidating trust's right to pursue claims against mortgage sellers and provided a discharge of all claims arising before the plan's effective date. The confirmation order enjoined creditors from pursuing discharged claims. Neither the debtor nor the estate had brought claims against the mortgage seller before the effective date, and the seller had not filed a proof of claim in the case. After the effective date, the liquidating trust sued the seller for breach of contract and indemnification under the client agreement. The seller counterclaimed for attorneys' fees under the contract, and the trust moved to enjoin the action as violating the discharge. The discharge covers a claim, whether or not contingent, that arose before the effective date. A claim does not arise before the effective date merely because the agreement under which it arises is a prepetition contract. A claim resulting from action that the reorganized debtor (or its successor) takes after the effective date does not arise prepetition, because a reorganization is not intended to shield the reorganized debtor from its post-reorganization activities, nor is a contract counterparty required to "guess" whether a reorganized debtor might breach a contract after reorganization and then file a contingent claim against the possibility. If the reorganized debtor returns to the fray after the effective date, then the debtor's obligations under the contract are post-discharge claims that survive the reoganization and discharge. Administrative expense priority case law applies only to obligations incurred by the estate in the administration of the case and is not relevant to the analysis here. Therefore, the court denies the motion to enjoin the counterclaims. *In re Residential Cap., LLC*, 541 B.R. 202 (Bankr. S.D.N.Y. 2015).

8.2 Third-Party Releases

8.2.a **Third party release in plan requires specificity.** Before bankruptcy, an employee asserted a Fair Labor Standards Act claim against the debtor and its prinicipal in the district court. The chapter 11 filing stayed the litigation. The debtor's plan provided a release of "officers and directors of the Debtor and the shareholder," without further elaboration. Under section 524(e), a discharge does not release third parties, but a plan that provides such a specific discharge or release is binding if the confirmation order is not reversed on appeal. Specificity requires more than the generic statement in this plan, such as by identifying the released parties or claims by name. Therefore, the plan did not effectively discharge the FLSA claim against the debtor's principal. *Hernandez v. Larry Miller Roofing, Inc.*, ___ F. Appx. ___, 2016 U.S. App. LEXIS 204 (5th Cir. Jan. 5, 2016).

8.2.b **Bankruptcy court may issue a bar order against a securities fraud case in a D&O breach of fiduciary duty settlement.** The debtor's audit committee members resigned after management obstructed the committee's investigation into matters raised by an SEC investigation. Senior management then abandoned their legal obligations to the debtor, which the state then dissolved. A plaintiff brought a securities class action against the debtor and its management, and another plaintiff brought an action against the directors and officers for breach of fiduciary duty, waste, and gross mismanagement. Only one officer defended; the others had fled the country. The debtor had a “wasting” D&O insurance policy, which was being depleted by the one officer’s defense of the litigation. Creditors filed an involuntary bankruptcy petition, which stayed both actions. The trustee negotiated a settlement of the fiduciary duty action with the insurer and the one officer conditioned on the bankruptcy court’s issuing a bar order against continued pursuit of the securities class action. Under Eleventh Circuit law, the bankruptcy court may issue a bar order if, among other things, the non-debtor third-party claims that are to be barred are “interrelated” with the estate’s claims. A claim is interrelated if it arises from the same set of facts and is against the same defendants. The barred claim need not be property of the estate or dependent on estate claims to be interrelated. Here, the securities class action claims and the fiduciary duty claims arise out of the same set of operative facts, including those underlying the SEC investigation and the company’s response. Therefore, the claims are interrelated, and the bankruptcy court may issue the bar order. *Brophy v. Salkin*, ___ B.R. ___, 2015 U.S. Dist. LEXIS 128331 (S.D. Fla. Sept. 24, 2015).

8.3 Environmental and Mass Tort Liabilities

9. EXECUTORY CONTRACTS

9.1.a **Section 365(n) does not protect an exclusive right to distribute patented products.** The debtor granted a distributor the exclusive right to market and distribute its patented products within a defined territory. The agreement also granted the distributor a nonexclusive license to use, reproduce, modify and create derivative works based on the debtor’s products. The debtor in possession moved to reject the agreement. Section 365(n) permits a licensee of intellectual property under a rejected contract to retain its right to use the intellectual property free from the trustee’s interference. Section 365(n) protection is limited to intellectual property rights, not to distribution rights. Section 365(n) does not convert an exclusive right to sell patented products into a protected right to the intellectual property itself. Therefore, the distributor does not retain the exclusive distribution right after the debtor in possession’s rejection of the agreement. However, it retains the nonexclusive right to use, reproduce, modify and create derivative works based on the debtor’s products, because those arise from the debtor’s intellectual property license to the distributor. *In re Tempnology, LLC*, 541 B.R. 1 (Bankr. D.N.H. 2015).

9.1.b **Section 1113 permits rejection of an expired collective bargaining agreement.** The National Labor Relations Act prohibits an employer from changing terms and conditions of employment unilaterally after a collective barganing agreement’s expiration unless the employer and the union have bargained to impasse. The debtor’s collective bargaining agreement expired a few days after it filed its chapter 11 petition. After an unsuccesful attempt to negotiate modifications, the debtor in possession moved to reject its obligations under the CBA. Section 1113 permits the trustee to reject a collective bargaining agreement after complying with notice, information, negotiation and court approval processes, giving the bankruptcy judge the authority to balance the needs of the reorganization against the labor interests that the NLRA protects. If section 1113 did not apply to an expired CBA whose obligations the NLRA continues, the bankruptcy judge would lose that authority to the NLRB, contrary to Congress’ intent to place authority in the bankruptcy court to facilitate reorganization. Therefore, section 1113 applies to the employer’s on-going obligations that the NLRA imposes after expiration of a CBA. *In re Trump Entertainment Resorts*, ___ F.3d ___, 2016 U.S. App. LEXIS 672 (3d Cir. Jan. 15, 2016).

10. INDIVIDUAL DEBTORS

10.1 Chapter 13

10.2 Dischargeability

10.2.a **Nonpayment of ERISA contributions is not defalcation while acting in a fiduciary capacity.** The debtor was the principal of a company that agreed to contribute to an ERISA-governed union welfare plan. The plan agreement provided that all contributions required to be paid were plan assets. When the company failed to make contributions, the debtor signed a promissory note to the plan. Unable to pay the note, he filed a chapter 7 case. The plan sought to hold the debt nondischargeable under section 523(a)(4), which makes nondischargeable a debt for defalcation while acting in a fiduciary capacity. Section 523(a)(4) applies only if the fiduciary relationship exists before nonpayment of the debt, not as a result of the nonpayment. Under ERISA, a person responsible for or who has control over plan assets is an ERISA fiduciary. Here, the asset is the plan's claim against the debtor, not the contribution that the debtor or his company did not make, despite the plan agreement provision. The debtor did not have control over the claim; the plan did. Therefore, the debtor was not an ERISA fiduciary with respect to the unpaid contributions, and the plan's claim is dischargeable. *Bos v. Board of Trustees*, 795 F.3d 1006 (9th Cir. 2015).

10.3 Exemptions

10.4 Reaffirmations and Redemption

11. JURISDICTION AND POWERS OF THE COURT

11.1 Jurisdiction

11.1.a **Bankruptcy court may enjoin nonbankruptcy litigation to further dispute resolution and reorganization.** The parent guaranteed a substantial amount of the subsidiary's debt. The parent engineered transactions to relieve itself of many of the guarantees, including causing transfers of the subsidiary's assets. Guaranteed creditors sued the parent on the guarantees. The subsidiary filed chapter 11, asserted fraudulent transfer claims against the parent arising out of the asset transfers, and asked the bankruptcy court to enjoin the creditors' action against the parent. Section 105(a) authorizes the bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. Section 105(a) grants bankruptcy judges extensive equitable powers to enable them to perform their statutory duties. One of the Code's central objectives is successful dispute resolution and reorganization. A bankruptcy judge may issue an order to further that objective as long as another Code provision does not limit the judge's power or discretion. The bankruptcy judge's authority to issue such an injunction is not limited to cases where the claims in the bankruptcy case and in the nonbankruptcy forum arise out of the same acts or involve the same parties. Here, the creditors' litigation against the parent could drain it of resources available to satisfy the estate's fraudulent transfer claim and thereby impair the subsidiary's ability to resolve disputes, distribute value to its creditors (including the guaranteed creditors), and reorganize. Therefore, the bankruptcy court may enjoin the guarantee litigation if it finds that negotiations in the chapter 11 case by enjoining the guarantee litigation might further that result. *Caesars Entertainment Operating Co., Inc. v. BOKF, N.A. (In re Caesars Entertainment Co., Inc.)*, ___ F3d ___, 2015 U.S. App. LEXIS 22579 (7th Cir. Dec. 23, 2015).

11.2 Sanctions

11.3 Appeals

11.3.a **Appeal from chapter 7 settlement approval order is not equitably moot.** The chapter 7 trustee settled two adversary proceedings. The first settlement did not involve payment or distribution of money, but it did result in dismissal of the settled litigation with prejudice. The second settlement involved the defendant's payment to the trustee and dismissal with prejudice, but the trustee had not yet distributed any of the funds as of the time of the appeal. The bankruptcy court approved the settlements and denied an objector's motion for a stay pending appeal. An appeal is equitably moot if the appellate court cannot grant effective judicial relief. To determine whether the court can grant effective relief, it must perform a multi-factor analysis, including whether a stay was obtained and if not, why not, whether the plan has been substantially consummated, the relief the appellant seeks, the relief's effect on parties not before the appellate court, and the effect on the debtor's emergence as a reorganized entity. Equitable mootness applies generaly to chapter 11 plan confirmation orders. The court here does not decide whether it should apply in a chapter 7 case but assumes it does. The appellant tried to obtain a stay but was blocked by the bankruptcy court's procedural maneuvering. The settlements were not clearly substantialy consummated, because the trustee had not distributed the proceeds to creditors. The transactions were not complicated or difficult to unwind. And reversal would not adversly affect third parties who were not before the court. The statute of limitations had run on both dismissed adversary proceedings, but the court suggests that equitable tolling would permit refiling. Therefore, court could grant effective relief, and the appeal is not equitably moot. *Ullrich v. Welt (In re NICA Holdings, Inc.)*, ___ F.3d ___, 2015 U.S. App. LEXIS 21991 (11th Cir. Dec. 17, 2015).

11.4 Sovereign Immunity

12. PROPERTY OF THE ESTATE

12.1 Property of the Estate

12.1.a **In bankruptcy of "stored value card" seller, card sale proceeds are not subject to a trust in favor of the card issuer.** The debtor retail store chain sold "stored value cards," which the purchaser could use like cash at other stores not related to the debtor. Intermediary companies issued the cards and collected sale proceeds from the debtor. The debtor's lender swept the debtor's cash accounts daily, but the debtor either retained sufficient proceeds from the card sales, or was advanced sufficient amounts by the lender, to pay the intermediary issuers for the cards. Shortly before bankruptcy, the debtor had inadequate cash to pay for cards it had sold. The issuer sued in the bankruptcy court to impose a trust on all the debtor's assets to pay for the unpaid cards, citing both the issuer's agreement with the debtor and state money transmitter statutes, which impose a trust on card sale proceeds and, if the proceeds are commingled with other money, on "all commingled money and other property." The statutory language imposes a trust only on commingled money and commingled other property, not on all other property. If it imposed a trust on non-commingled property, it would apply in a bankruptcy case only to the extent not inconsistent with federal law. The Bankruptcy Code looks first to state law to determine the debtor's interest in property but determines priorities among creditors without reference to state law. Section 545 provides a general template to determine whether a state statute granting a lien or a trust interest is really a disguised priority. If the state-created right arises only on bankruptcy or insolvency or is invalid against a bona fide purchaser, the trustee may avoid it as a disguised state-created priority. Even where the right is not avoidable, the trust may apply only to assets that can be traced to the assets on which the state statute imposes the trust, based on applying general tracing rules such as the lowest intermediate balance rule. In this case, because the debtor's lender swept the card sale proceeds daily, the trust account's lowest intermediate balance was zero. Therefore, none of the estate's assets are subject to the trust, and the issuer's claim is a general unsecured claim. *Blackhawk Network, Inc. v. Alco Stores, Inc. (In re Alco Stores, Inc.)*, 538 B.R. 383 (Bankr. N.D. Tex. 2015).

12.1.b ***In pari delicto* doctrine is a defense to the faithless servant doctrine.** The corporate debtor and several of its officers and senior employees were convicted in a kickback scheme. The trustee sued an employee who participated in the scheme but who was not convicted to recover all the employee's compensation and legal fees the debtor incurred associated with the criminal investigation. The faithless servant doctrine allows an employer to recover compensation paid to an employee who acts contrary to the employer's interest. The *in pari delicto* doctrine prohibits a wrong-doer from recovering damages from another wrong-doer in the same scheme. An employee acts as the employer's agent; agency law imputes the agent's acts and knowledge to the principal. Under New York's broad interpretation of the *in pari delicto* doctrine, the only exception to the doctrine is the adverse interest exception—where the employee totally abandons the employer's interests and acts entirely for his or her own purposes. The adverse interest exception does not apply where the employee's actions benefit both the employee and the employer. (*In pari delicto* allows a corporation's claim against a controlling insider who breaches a fiduciary duty to the corporation, but it does not admit of a general "insider" exception.) And the faithles servant doctrine is not an exception. Therefore, the trustee may not pursue the faithless servant claim against the employee. *Flaxer v. Gifford (In re Lehr Constr. Corp.)*, ___ B.R. ___, 2016 U.S. Dist. LEXIS 4022 (S.D.N.Y. Jan. 12, 2016).

12.2 Turnover

12.3 Sales

13. TRUSTEES, COMMITTEES, AND PROFESSIONALS

13.1 Trustees

13.1.a **Trustee succeeds to audit committee's attorney-client privilege.** The Cayman debtor's board of director's audit committee retained counsel to conduct an investigation into allegations that might have involved violation of U.S. securities laws. After the investigation, a creditor filed a winding up petition against the debtor in the Cayman Islands. The Cayman liquidator obtained recognition in the U.S. under chapter 15 and then sought documents from the audit committee's counsel, which asserted attorney-client privilege under U.S. law as a ground to withhold documents. Federal Rule of Evidence 501 governs privilege. Where, as here, federal law provides the rule of decision, federal common law also determines privilege choice of law. The "touch base" doctrine, which bases privilege choice of law on which jurisdiction has the predominant or most direct and compelling interest in governing privilege, applies. In this case, that is the United States. The internal affairs doctrine applies the law of a corporation's domicile to matters of corporate governance and structure. If that doctrine applied here, the court might have to determine whether the debtor's audit committee was a separate entity from the debtor and therefore entitled to assert or waive separately from the debtor. However, that doctrine does not apply because only privilege law governs the issues here. Under *CFTC v. Weintraub*, 471 U.S. 343 (1985), a trustee in bankruptcy succeeds to a corporation's privilege. An audit committee is a committee of the board and therefore part of the corporation. Moreover, its interests, to the extent they are adverse to management involved in wrongdoing, are aligned with the trustee's interests. Therefore, the liquidator succeeds to the privilege and is entitled to turnover of documents that were withheld on attorney-client privilege grounds. *Krys v. Paul, Weiss, Rifkind, Wharton, & Garrison LLP (In re China Med. Techs., Inc.)*, 539 B.R. 643 (S.D.N.Y. 2015).

13.2 Attorneys

13.3 Committees

13.4 Other Professionals

13.5 United States Trustee

14. TAXES

15. CHAPTER 15—CROSS-BORDER INSOLVENCIES

15.1.a **New York law-governed and enforceable indenture is property in New York for chapter 15 eligibility purposes.** The Singapore-based debtor issued bonds under a New York-law governed indenture, naming a New York bank as indenture trustee and consenting to jurisdiction in New York courts. It opened an insolvency proceeding in Singapore, and its foreign representative sought recognition under chapter 15. Under controlling Second Circuit law, section 109(a), which requires a residence, domicile, place of business or property in the United States as a condition to eligibility to be a debtor in a title 11 case, applies in chapter 15. Intangible property suffices to meet the requirement. A contract and the rights it creates are intangible property. Under New York law, intangible property may have more than one situs, depending on the purpose of the analysis. The indenture requires the notes to be discharged in New York, and the indenture and New York law permit enforcement of the contract in the New York courts, fixing the situs of the contract and the contract rights in New York. Therefore, the foreign representative is eligible to file the chapter 15 case in New York. The court also notes the potential irony if it ruled otherwise of permitting creditors to sue the debtor on the indenture in New York but not permitting it to commence a chapter 15 case there to address its liability on the bonds. *In re Berau Cap. Res. Pte Ltd.*, 540 B.R. 80 (Bankr. S.D.N.Y. 2015).

15.1.b **Liquidators' minimal activities in the forum state does not shift the debtor's COMI to the forum.** A creditor obtained a large judgment in a UK court against a BVI "letterbox" company that operated primarily in London. The company had no operations in the BVI. Immediately after the court issued judgment, the debtor transferred nearly $10 million from London to other jurisdictions. It then filed a voluntary liquidation proceeding in the BVI, with its principals guaranteeing compensation for the liquidator only sufficient for minimal administration of the estate. The liquidator in fact did only the minimum and did almost nothing to pursue the debtor's pre-liquidation transfers, which would have been recoverable under English or BVI law. The company had unliquidated assets in New York, and the creditor had been pursuing collection there. The liquidator filed a petition for recognition in New York. The court must grant a petition for recognition if, among other things, the foreign proceeding is in the debtor's center of main interest (COMI). If a liquidator has taken over the debtor's operations in its letterbox jurisdiction and has conducted substantial activities there, the debtor's COMI might shift to the liquidator's location. However, in this case, the liquidator did not conduct any substantial operations, even in the liquidation proceeding, so the debtor's COMI remained in the UK. Therefore, the court denied recognition. *In re Creative Fin. Ltd.*, ___ B.R. ___, 2016 Bankr. LEXIS 103 (Bankr. S.D.N.Y. Jan. 13, 2106).

15.1.c **Foreign representative may bring unjust enrichment claim that seeks relief similar to a fraudulent transfer claim.** The New York bankruptcy court granted recognition to the foreign representatives of a U.K. foreign main proceeding. The foreign representatives sued under U.K. fraudulent transfer law and under unjust enrichment law to avoid and recover the debtor's transfers to its parent entities and their shareholders. Section 1521(a)(7) permits the bankruptcy court to grant a foreign representative "additional relief, except for relief available under sections 522, 544, 545, 547, 548, 550, and 724(a)." Although an unjust enrichment claim might seek the same relief as to the same transfers as a fraudulent transfer claim, the claims are not identical. An unjust enrichment claim is a common law claim that exists independently of a bankruptcy case. A fraudulent transfer claim seeks to void a transaction. A plaintiff may seek rescission for an unjust enrichment claim, but the primary purpose of such a claim is restitution, not voiding. Therefore, the claims are not identical, and section 1521(a)(7) does not bar a court from permitting a foreign representative to pursue an unjust enrichment claim in a chapter 15 case. *Hosking v. TPG Cap. Mgmt., L.P. (In re Hellas Telecomm. (Luxembourg) II SCA)*, 535 B.R. 543 (Bankr. S.D.N.Y. 2015).