JENNER&BLOCK

Recent Developments in Bankruptcy Law, July 2016

(Covering cases reported through 550 B.R. 151 and 822 F.3d 451)

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2.1.a **Section 546(e) safe harbor does not bar state law fraudulent transfer claim against bad faith LBO seller of private securities.** The closely-held debtor's shareholders caused its board to falsify its financial statements. They then conducted a sale process, which culminated in an LBO. After the acquisition, the debtor filed chapter 11. The chapter 11 plan provided for creditors to assign their state law fraudulent transfer claims against the selling shareholders to a litigation trust, which sued the shareholders to avoid and recover the payments for their shares under state constructive fraudulent transfer law. Section 546(e) prohibits the trustee from avoiding a settlement payment made by or to a financial institution in connection with a securities contract. By its terms, it does not apply to creditors' claims to avoid such payments. Federal law preempts state law either impliedly, by occupying the field or if the state law erects an obstacle to Congress' purpose in enacting the federal law, or expressly. Section 546(e) does not expressly preempt state law, because it refers only to the trustee, so preemption could only be implied. There is a presumption against preemption where Congress acts in a field that the states have historically occupied. Fraudulent transfer law is such a field. Congress' purpose in section 546(e) appears to have been to protect securities markets, not individual participants in the markets, and to prevent a bankruptcy from causing a ripple effect in the markets. Therefore, section 546(e)'s safe harbor does not apply to a state fraudulent transfer claim where the targeted transaction poses no threat of a ripple effect in the securities market, the securities were not publicly traded and the transferees were corporate insiders who acted in bad faith. *PAH Litigation Trust v. Water St. Healthcare P'ners L.P. (In re Physiotherapy Holding, Inc.)*, ___ B.R. ___ (Bankr. D. Del. June 20, 2016).

2.1.b **The debtor's release of claims against selling LBO shareholders does not bar a fraudulent transfer claim.** After the debtor's LBO, the debtor released the selling shareholders from "any claims for losses, damages, indemnification, or other payment … for any breach, violation or inaccuracy of any of the terms, conditions, covenants, agreements or representations and/or warranties in the Merger Agreement." The debtor's chapter 11 plan provided for creditors to assign their state law fraudulent transfer claims to a litigation trust, which sued the selling shareholders to avoid and recover the payments for their shares as fraudulent transfers. The Code's avoiding powers are vested in the trustee and do not derive from any rights that the debtor had as of the commencement of the case. Accordingly, a debtor's release of claims does not bind affect the trustee or the creditors' rights to bring avoiding power claims. *PAH Litigation Trust v. Water St. Healthcare P'ners L.P. (In re Physiotherapy Holding, Inc.)*, ___ B.R. ___ (Bankr. D. Del. June 20, 2016).

2.1.c Substantive consolidation does not augment the trustee's section 544(b) avoiding powers by allowing the trustee to rely on predicate creditors from another estate. The trustee of the substantively consolidated the estates of several related Ponzi-scheme debtors sued under section 544(b) to recover fraudulent transfers, relying on the unsecured creditors of the consolidated estates as the predicate creditors, because the transferor debtor had no prepetition creditors of its own. Substantive consolidation merges only the assets and liabilities of separate estates, not the separate debtor entities, and does not change the trustee's avoiding power rights. Substantive consolidation does not supply the missing predicate creditor, so the transferor debtor's lack of a predicate creditor prevents the trustee's from relying on section 544(b) to avoid transfers. *Kelley v. Opportunity Finance, LLC (In re Petters Co., Inc.)*, 550 B.R. 438 (Bankr. D. Minn. 2016).

2.1.d **Ponzi scheme LLC does not receive value for paying its member's taxes.** The debtor LLC was part of a Ponzi scheme. It was a pass-through entity for tax purposes. It paid directly to the IRS the taxes of one of its members under an operating agreement that permitted but did not require it to do so. The LLC could have elected not to be a pass-through entity, but the member's tax payment was about 15% less than if the LLC were a taxable entity and had paid its own tax obligation. The trustee may avoid a transfer made with actual intent to hinder, delay or defraud creditors, unless the transferee received the transfer for value in good faith. The savings from the LLC's tax status does not constitute value to the LLC, because it was not in fact subject to federal income tax, and whether it could or would choose another tax status is speculative. A debtor might receive value in paying its member's obligation if it received a benefit from doing so. Here, the LLC did not receive value by paying its member's taxes because it was not under an obligation to the member to do so. *Zazalli v. Swenson (In re DBSI, Inc.)*, ___ B.R. ___, 2016 U.S. Dist. LEXIS 78202 (D. Id. May 16, 2016).

2.1.e **Access to a credit line rebuts unreasonably small capital claim.** The debtor had a substantial undrawn bank credit line. The debtor engaged in speculative trading, in violation of the credit agreement terms, resulting in substantial losses. The debtor drew on the credit line to remain liquid. Ultimately, the debtor transferred the trading book, and soon thereafter, the banks called a default under the credit agreement, but not because the trading activity violated the credit agreement. After beginning the trading activity and before the default, the debtor paid dividends to its shareholders. After bankruptcy, the trustee sued to avoid and recover the dividend payments as fraudulent transfers, alleging that the debtor had unreasonably small capital when it paid the dividends. A debtor is adequately capitalized if it can borrow amounts necessary to remain liquid. Here, the debtor was able to do so, but the trustee disputed that based on the trading activity, which defaulted the line. Because the banks did not actually call a default until after the debtor transferred the trading book and only for other reasons, any examination of whether the debtor could have drawn if the banks had either known of or focused on the prohibited trading was too speculative and could not form the basis for an unreasonably small capital finding. *In re SemCrude L.P.*, ___ Fed. Appx. ___, 2016 U.S. App. LEXIS 7690 (3d Cir. Apr. 28, 2016) (unpub.)

2.2 Preferences

2.2.a **Funds passing through a lockbox account and re-advanced to the debtor remain subject to a security interest.** The debtor granted its inventory supplier a perfected first priority security interest in its accounts and its lender a second priority security interest in the accounts as well as a blanket security interest on other assets. The lender required the debtor to establish a lockbox account, into which the debtor's customers paid their invoices, and in which the lender took a security interest. The lender swept the lockbox daily and advanced funds to the debtor from the debtor's credit line upon the debtor's request. The debtor used the advances to pay the supplier's invoices, among other things. If a debtor transfers to a creditor property in which the creditor has a perfected security interest, there is no preference, because the transfer fails the greater percentage test of section 547(b)(5). The supplier maintained its security interest in the accounts receivable when the customers paid them into the lockbox account, because a perfected security interest continues in identifiable proceeds of collateral, and the funds in the account were proceeds of the receivables. U.C.C. section 9-332(b) provides that "a transferee of funds from a deposit account takes the funds free of a security interest in the deposit account." This provision protects the supplier's security interest in the funds from the lender's security interest in the account, though it does not protect the lender from the supplier's security interest in the funds. Therefore, the supplier's security interest in the funds continues after they are transferred to the lender. U.C.C. section 9-315(b)(2) provides that commingled proceeds "are identifiable proceeds … to the extent that the secured party identifies the proceeds" by a reasonable tracing measure.

While the U.C.C. places that burden on the secured party, section 547(g) places the burden of proof in a preference action on the trustee. Therefore, the trustee needs to show that the lockbox sweep and the lender's commingling of the funds before being re-loaned to the debtor did not make the proceeds unidentifiable. Because the trustee did not do so here, section 9-315(b) leads to the conclusion that the re-loaned funds that the debtor used to pay the supplier remained subject to the supplier's security interest. As a result, the supplier payments were not preferences. *Garner v. Knoll, Inc. (In re Tusa-Expo Holdings, Inc.)*, 811 F.3d 786 (5th Cir. 2016).

2.2.b **Provisional credit does not create an antecedent debt.** The debtor did not have sufficient funds in its bank account to cover checks that were presented for payment. The bank provisionally honored the checks and contacted the debtor to deposit funds necessary to cover, which the debtor did the next day. Under U.C.C. section 4-301(1), a bank may provisionally settle a check presented during the day and may still return the check before midnight on the next day. If it does not return by the "midnight deadline," the settlement is final. A transfer is not a preference unless it is for or on account of an antecedent debt. The bank's provisional honoring of the check does not create a debt from the debtor to the bank, because the bank can reverse the transaction the next day without any liability to the bank or the debtor. The debt arises only when the bank does not return the check by the midnight deadline. Therefore, the debtor's deposits into the bank account to cover the provisionally honored checks is not a transfer for or on account of an antecedent debt. *Sarachek v. Luana Sav. Bank (In re Agriprocessors, Inc.)*, 547 B.R. 292 (N.D. Iowa 2016).

2.3 Postpetition Transfers

2.4 Setoff

2.5 Statutory Liens

2.6 Strong-arm Power

2.7 Recovery

2.7.a **Section 560 protects collateral distribution upon termination of a swap with the debtor.** The debtor entered into several transactions involving a credit default swap between the debtor and synthetic collateralized debt obligation SPVs (issuers), which issued notes under an indenture. The notes' proceeds were held as collateral for the issuers' obligations under both the notes and the swaps. After the debtor filed bankruptcy, the indenture trustee sent a notice of default and termination under the swaps, liquidated the collateral and distributed the proceeds to the noteholders. Section 560 exempts from the automatic stay and the avoiding powers "the exercise of any contractual rights of any swap participants … to cause the liquidation, termination or acceleration of one or more swap agreements" based on an ipso facto clause. Courts interpret section 560 broadly to protect swap participants. The section protects not only the liquidation of the amount owing upon swap termination, but also the liquidation of the collateral and its distribution to the noteholders. Therefore, the court dismisses the debtor in possession's complaint to avoid and recover the distributions. *Lehman Bros. Special Financing Inc. v. Bank of Am., N.A. (In re Lehman Bros. Holdings Inc.)*, ___ B.R. ___, 2016 Bankr. LEXIS 2405 (Bankr. S.D.N.Y. June 28, 2016).

3. BANKRUPTCY RULES

3.1.a **Lack of notice denies due process if the claimant is unable to participate in bankruptcy negotiations for a better deal.** The debtor manufactured products with a serious defect, which it concealed. It filed a chapter 11 case, gave publication notice and extensive direct notice, but not direct notice to its customers who bought the defective product, and sold its assets under section 363 to a newly formed entity free and clear of all claims and interests, including successor liability claims. The product defect was revealed several years later, and people injured by the defect sued the buyer under a successor liability theory. The buyer relied on the sale order. The bankruptcy court found that, addressing objections from other parties in the original sale hearing, it had ruled on all the legal objections the injured plaintiffs now raised to the breadth and scope of the sale order's free and clear provision and determined that despite the lack of direct notice, the plaintiffs were not legally prejudiced. The court of appeals reversed. Due process requires actual notice to known creditors. Whether or not a denial of due process claim requires a showing of prejudice, the lack of notice here was the defect's concealment. That prejudiced the plaintiffs by preventing them from participating in the case and thereby negotiating a better deal for themselves. Therefore, the bar provision in the sale order did not bar the plaintiffs' claims. *Elliott v. General Motors LLC*, ___ F.3d ___, 2016 U.S. App. LEXIS 12848 (2d Cir. July 13, 2016).

3.1.b **Privileges might apply to litigation funder communications.** The creditor funded its litigation and collection efforts, including an involuntary petition, against the debtor under an agreement with a litigation funding company. The debtor interposed a bad faith defense and sought discovery of communications among the creditor, his counsel and the litigation funding company to support its theory. Attorney-client communications are privileged and not subject to discovery but lose their privilege if disclosed to a third party. However, if the third party has a common interest with the client, then the privilege survives. Some courts use a narrower common legal interest test, others use a broader common commercial interest test, to determine common interest. The latter requires both necessity of the disclosure to obtain legal advice to assist the parties' common purpose, which would not be made outside the privilege, and an intention to keep the contents of the disclosure confidential. A litigation funding arrangement meets all these tests. A communication may also be privileged under the "agency exception," whose application requires that communication with the third party be in furtherance of the rendition of legal services. Communication with a litigation funder also meets this test. Attorney work product is also privileged and not subject to discovery unless the information involves only facts, not mental impressions, conclusions, opinions or theories, and cannot be obtained elsewhere. Counsel's communications with the litigation funder over litigation strategy and risks qualifies as privileged work-product to which the exceptions do not apply. The litigation funding agreement's terms are work product but are at issue in the debtor's bad faith defense and so are subject to disclosure except to the extent of attorney mental impressions and opinion and payment terms. *In re Int'l Oil Trading Co., LLC*, 548 B.R. 825 (Bankr. S.D. Fla. 2016).

4. CASE COMMENCEMENT AND ELIGIBILITY

4.1 Eligibility

4.1.a **Puerto Rico may not enact composition statute.** Puerto Rico's legislature adopted the Puerto Rico Corporation Debt Enforcement and Recovery Act, which provided a means to adjust its instrumentalities' debts through a Puerto Rico court proceeding in which the holders of a majority of claims could bind a class to a debt adjustment. Bankruptcy Code section 903(1) provides that chapter 9 does not limit a State's power to control its municipalities, but "a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition." Section 101(52) defines "state" to include Puerto Rico, "except for the purpose of defining who may be a debtor under chapter 9." Section 109(c) permits only municipalities of a State to be a chapter 9 debtor, and section 103(g) provides that chapter 9 applies in a case under chapter 9. Because the "state" definition excludes Puerto Rico only for chapter 9 eligibility purposes, Puerto Rico's exclusion from chapter 9 eligibility does not affect the application of section 903(1), which applies and prohibits Puerto Rico from enacting a composition statute. *Commonwealth of Puerto Rico v. Franklin Calif. Tax-Free Trust*, 579 U.S. ___, 136 S. Ct. 1938 (2016).

4.1.b **LLC operating agreement requiring lender member to consent to bankruptcy petition is unenforceable.** As part of a forbearance agreement, the debtor LLC agreed to sell one common interest unit to the creditor for $1 and to amend the LLC agreement to require unanimous consent to authorize the LLC to file a bankruptcy petition. An agreement not to file a bankruptcy petition or to waive a bankruptcy discharge are unenforceable as against federal public policy. Parties may not accomplish "by circuity of arrangement" what they may not accomplish directly. Here, both parties intended to contract away the debtor's right to file bankruptcy. "A provision in a limited liability company governance document obtained by contract, the sole purpose and effect of which is to place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the nature and substance of whose primary relationship with the debtor is that of creditor—not equity holder—and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy." *In re Intervention Energy Holdings, LLC*, ___ B.R. ___, 2016 Bankr. LEXIS 2241 (Bankr. D. Del. June 3, 2016).

4.2 Involuntary Petitions

4.2.a **Creditor may rely on undisputed portion of stayed judgment to qualify as holding a claim not subject to bona fide dispute.** The creditor obtained a state court judgment against the debtor on four notes that the debtor's wholly owned corporation had issued, only two of which the debtor had guaranteed. The debtor appealed. State law stayed collection on the judgment pending appeal. The creditor joined with two other creditors in filing an involuntary petition against the debtor. In the bankruptcy case, the debtor conceded liability on the guaranteed notes, and the creditor conceded no liability on the non-guaranteed notes. A creditor is eligible to file an involuntary petition only if the creditor's claim "is not … the subject of a bona fide dispute as to liability or amount." A claim is subject to bona fide dispute if there is either a genuine issue of material fact or a meritorious legal contention that bears on liability. A state court judgment would ordinarily automatically negate the existence of a bona fide dispute, but where enforcement is stayed, the "claim" is not yet automatically an undisputed "right to payment." The state court judgment bears on whether there is a bona fide dispute, but here, the state court's judgment on the non-guaranteed notes and the creditor's concession calls into question whether the entire claim remains subject to a bona fide dispute. However, the creditor may rely on a severable, undisputed portion of a claim under a stayed judgment to qualify as a petitioning creditor if the debtor is not prejudiced by the reliance. In this case, the debtor's liability on the guaranteed notes was sufficient to qualify the creditor as a petitioning creditor. *Fustolo v. 50 Thomas Patton Dr., LLC*, 816 F.3d 1 (1st Cir. 2016).

4.2.b **Court dismisses involuntary petition used to resolve shareholder disputes for bad faith.** The debtor owned raw land that it hoped to develop into a casino. It borrowed, including from its shareholders, to fund the development. The land was worth substantially more than the debt. But after 15 years, the debtor had made little development progress. Shareholders who were also creditors unsuccessfully attempted at a shareholder meeting to oust management, with whom they had become increasingly frustrated. Soon thereafter, some of those shareholders filed an involuntary petition against the debtor. Though the shareholder-creditors contended their purpose was to protect the property and collect on their notes, the court found their purpose was principally to change management. A court should dismiss an involuntary petition that is filed in bad faith. Determining bad faith is based on the totality of the circumstances. An involuntary petition is not to be used as a collection device. Creditors may not use an involuntary petition to obtain a disproportionate advantage over other creditors. Similarly, shareholders may not use an involuntary petition to gain a disproportionate advantage over other shareholders. Shareholder disputes are not appropriately remedied by an involuntary petition, and vindicating shareholder rights are not a proper purpose for a bankruptcy case. Here, the shareholder-creditors' involuntary petition soon after their failed attempt at the shareholder meeting to change management was an improper attempt to upend the shareholder vote, shows their desire to use the petition to settle a shareholder dispute and gain an inordinate advantage over other shareholders and, if their stated purpose was in fact to collect on their notes, improperly use bankruptcy as a collection device. Finding the totality of the circumstances to be bad faith, the court dismisses the petition. *In re Diamondhead Casino Corp.*, ___ B.R. ___, 2016 Bankr. LEXIS 2450 (Bankr. D. Del. June 7, 2016).

4.3 Dismissal

5. CHAPTER 11

5.1 Officers and Administration

5.1.a **Adequate protection requires only protection of a secured creditor's petition date claim amount.** Because the secured creditor appeared substantially oversecured at the beginning of the case, the court authorized the debtor in possession to use cash collateral but required adequate protection payments. When the case converted to chapter 7, the secured creditor remained oversecured, but less so. It collected the proceeds of its collateral, which covered all principal and prepetition interest but only a portion of postpetition interests and costs and expenses. A secured creditor is entitled to a superpriority claim under section 507(b) if the court granted inadequate adequate protection and the creditor has an allowable administrative expense claim arising from the automatic stay, the use, sale or lease of the collateral or a superpriority borrowing. Adequate protection entitles a secured creditor to protection of its interest in property of the estate. Its interest is equal to its petition date principal and interest, not to the value of its collateral or of any equity cushion. Here, the secured creditor was oversecured on both the petition date and on the chapter 7 conversion date. Therefore, the protection it received was adequate, and it is not entitled to a superpriority claim for the amount of postpetition interest, costs and expenses it would have received if the collateral value had retained its petition date value. *Branch Banking and Trust Co. v. Beaman (In re Construction Supervision Servs., Inc.)*, ___ B.R. ___, 2016 U.S. Dist. LEXIS 61444 (E.D.N.C. May 9, 2016).

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 **Court requires postpetition interest at the contract rate in a solvent case.** The trustee confirmed a plan that paid all creditors in full, with postpetition interest at the federal judgment rate, and returned a surplus to equity holders. One creditor objected to the interest rate. Section 502(b)(2) disallows postpetition interest. Section 726(a)(5) provides for payment of postpetition interest in a solvent chapter 7 case "at the legal rate." Section 1129(a)(7) requires as a confirmation condition that holders of claims in an impaired class receive at least as much as they would receive in a chapter 7 case. Section 1124 provides that a plan impairs a class unless the plan does not alter the legal, equitable or contractual rights of the claims in the class (except for possible reinstatement and cure). Generally, courts should interpret the Code not to alter pre-Code practice unless a specific Code provision so provides. Historically, creditors were entitled to postpetition interest at their contract rates in a solvent case. Section 726(a)(5) is ambiguous on whether the phrase "the legal rate" changes that practice. A better reading, consistent with pre-Code law, is interest at a rate appropriate under federal bankruptcy law. Because that has historically been the contract rate, the court should enforce creditors' rights and use the contract rate in a solvent case for the class of claims to be unimpaired. *Colfin Bulls Fundings A, LLC v. Paloian (In re Dvorkin Holdings, LLC)*, 547 B.R. 880 (N.D. Ill. 2016).

6.2 Priorities

6.2.a **For purposes of section 503(b)(9), the debtor "receives" good shipped FOB when placed on board.** The creditor shipped goods FOB (free on board) from China more than 20 days before the date of the filing of the petition. The debtor took physical possession of the goods when they arrived in the United States, within 20 days before the date of the filing of the petition. Section 503(b)(9) gives a creditor an administrative priority claim if the debtor received the creditor's goods within 20 days before the date of the filing of the petition. The Code does not define "receive." U.C.C. section 2-103(1)(c) defines "receipt" as "taking physical possession". However, where federal law (including a treaty) provides a rule of decision, it preempts state law. The Convention on Contracts for the International Sale of Goods (CISG), which the Senate ratified, does not contain a definition of "receive." But it requires interpretation questions "to be settled in conformity with the general principles on which [the CISG] is based or, in the absence of such principles, in conformity with the law applicate by virtue of the rules of private international law," § 7(2), and that "the parties are considered, unless otherwise agreed, to have impliedly made applicable to their contract" common usage. § 9(2). "Incoterms," which are defined terms adopted by the International Chamber of Commerce, provides that "FOB" means the "risk of loss or damage passes when the goods are on board the vessel, and the buyer bears all costs from that moment forward." Based on that definition, in the context of an FOB shipment, "received" in section 503(b)(9) means when the goods are placed on board. In this case, that occurred more than 20 days before the petition date, so the court disallows the creditor's administrative expense claim. *Fujian Zhangzhou Foreign Trade Co., Ltd. v. World Imports, Ltd. (In re World Imports, Ltd.)*, 549 B.R. 820 (E.D. Pa. 2016).

7. CRIMES

8. DISCHARGE

8.1 General

8.2 Third-Party Releases

8.3 Environmental and Mass Tort Liabilities

9. EXECUTORY CONTRACTS

9.1.a **Ipso facto clause invalidation does not apply to a cross-default caused by the debtor's parent's filing.** The debtor entered into several transactions involving a credit default swap between the debtor and synthetic collateralized debt obligation SPVs (issuers), which issued notes under an indenture. The notes' proceeds were held as collateral for the issuers' obligations under both the notes and the swaps. Some security agreements (Type 1) provided that the security interest of the debtor, as swap counterparty, had priority over the security interest of the noteholders, unless the debtor defaulted under the swap and amounts became payable after sale of the collateral, in which case the priority "flipped" to the noteholders. Other security agreements (Type 2) did not specify whether the debtor or the noteholders had priority rights in the collateral but specified in a waterfall which party would receive collateral proceeds based on the event that triggered the collateral liquidation and distribution. The debtor's parent guaranteed the debtor's performance under the swaps. The parent filed bankruptcy, defaulting the swaps. The debtor filed bankruptcy three weeks later. Indenture trustees for some of the note issues sent a notice of default under the swaps upon the parent's bankruptcy filing; others waited until after the debtor's filing. After termination, the indenture trustees liquidated the collateral and distributed the proceeds to the noteholders. An executory contract is a contract under which the obligations of the debtor and the counterparty are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other. The swaps' outstanding payment obligations make them executory contracts. Section 365(e) prohibits the enforcement after the commencement of the debtor's case of a contractual provision that modifies or terminates a debtor's rights under an executory contract based on "the commencement of a case under this title." Because the prohibition applies after the commencement of the debtor's case, it does not prohibit prepetition modification based on the parent's earlier bankruptcy case. Accordingly, the court refuses to apply the "singular event" theory suggested in dictum in *Lehman Bros. Special Financing Inc. v. BNY Corp. Trustee Servs. Ltd. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010). Therefore, termination notices given before the commencement of the debtor's case did not modify any rights after the commencement of the case and do not violate section 365(e)'s anti-ipso facto provisions. However, a termination notice given after commencement in a Type 1 transaction does violate section 365(e), because if flips priority and therefore modifies rights postpetition. A postpetition termination notice in a Type 2 transaction does not, because the priority is not established until the event of default occurs and the termination notice is given, so there is no postpetition modification. *Lehman Bros. Special Financing Inc. v. Bank of Am., N.A. (In re Lehman Bros. Holdings Inc.)*, ___ B.R. ___, 2016 Bankr. LEXIS 2405 (Bankr. S.D.N.Y. June 28, 2016).

9.1.b **Court authorizes contract rejection under business judgment standard in dueling bankruptcies.** The debtor in possession moved to reject an executory contract. The contract counterparty, a debtor in possession in an unrelated case in a different district, had moved in its case to assume the contract. The "business judgment" standard governs the court's approval of contract rejection; a "balancing of the equities" test does not apply. The business judgment standard does not consider rejection's effect on the contract counterparty, even if the counterparty is a debtor in possession in its own bankruptcy. Therefore, once the debtor in possession shows that rejection is based on a sound exercise of business judgment, the court may authorize rejection, despite the counterparty's bankruptcy. The parties did not address whether rejection might violate the stay in the other case. *In re Noranda Aluminum, Inc.*, 549 B.R. 725 (Bankr. E.D. Mo. 2016).

9.1.c **Contingent self-executing release obligation is a material obligation for the purpose of determining whether a contract is executory.** The debtor condominium developer and the homeowners association settled disputes by agreeing that the debtor would transfer common areas to the association, and that the association, upon delivery of the deed, automatically releases the debtor. Before it delivered the deed, the debtor filed a bankruptcy petition and moved to reject the contract. A contract is executory if material performance remains on both sides, such that one party's failure to perform would excuse the other's performance. Here, the debtor has the material obligation to convey the property, while the association has the material obligation to release the debtor. A contingent obligation remains an obligation, even though the contingency might not occur. The self-executing nature of an obligation does not affect whether it remains executory, because it remains a duty. Here, the contingent nature of the duty to release and its self-executing nature do not render the contract non-executory. *In re Spoverlook, LLC*, 551 B.R. 481 (Bankr. D.N.M. 2016).

9.1.d **Trustee may reject pre-paid contract for legal services and recover unused fees.** The debtor paid his attorney a non-refundable, earned-upon-receipt $60,000 retainer before bankruptcy to defend expected nondischargeability litigation. The engagement agreement required the debtor to pay costs and expenses that the attorney incurred in the defense. After bankruptcy, the trustee rejected the engagement agreement and demanded a refund of the retainer. Section 541(a)(1) includes as property of the estate any interest of the debtor in property. Because the debtor paid the retainer in full before bankruptcy and the attorney was entitled to it under nonbankruptcy law, the retainer was not property of the estate. However, the debtor's right to legal services became property of the estate. An executory contract is one under which material performance remains due on both sides, such that one party's failure to perform would excuse the other party's performance. The attorney had the continuing obligation to defend the litigation; the debtor had the obligation to pay costs and expenses. Both obligations were material. Therefore, the contract was executory, and the trustee may reject it. Rejection constitutes a breach, not a termination or a rescission. The estate's rights under the contract against the counterparty remain. In this case, those rights include a right to a refund of the "unused" portion of the retainer. Therefore, the attorney must pay the trustee the amount "remaining" on the retainer as of the date the trustee terminated the attorney's services. *Ulrich v. Schian Walker, P.L.C. (In re Boates)*, 551 B.R. 428 (9th Cir. B.A.P. 2016), *reh'g denied*, 2016 Bankr. LEXIS 2541 (9th Cir. B.A.P., July 8, 2016).

9.1.e **Aircraft surrender under section 1110 does not require compliance with lease surrender terms.** Shortly after commencement of the chapter 11 case, the debtor in possession moved to reject aircraft leases and surrender the leased airframes and engines. The debtor had changed engines on some of the airframes, so some leased airframes had engines that were not leased from the same lessor, and the originally matching airframes and engines were in different locations. Section 1110(c) requires the debtor in possession to surrender and return equipment immediately under a lease rejected under section 365. However, it requires no more. Section 365's purpose is to permit the estate to abandon burdensome property and to excuse compliance with burdensome obligations. Requiring the debtor in possession to comply with burdensome lease provisions after lease rejection would be inconsistent with that purpose. Therefore, the debtor in possession may make the equipment available to the lessor as is, where is, for the lessor to pick up. The court rules that any claim the lessor might have from the debtor in possession's noncompliance with the lease surrender provisions should be addressed in the claims allowance process, not as part of the lease rejection. *In re Republic Airways Holdings Inc.*, 547 B.R. 578 (Bankr. S.D.N.Y. 2016).

10. INDIVIDUAL DEBTORS

10.1 Chapter 13

10.2 Dischargeability

10.2.a **Actual fraudulent transfer constitutes "actual fraud" for purposes of nondischargeability under section 523(a)(2)(A).** The individual debtor owned at least a 30% interest in a company that purchased goods from a creditor. After the purchases, the debtor caused the purchaser to transfer substantial amounts of cash to other companies that the debtor owned and controlled, leaving the purchaser unable to pay the creditor. The debtor admitted the transfers were actual fraudulent transfers. The creditor sued the debtor, claiming that the transfers were "actual fraud" for purposes of a state statute that allows a creditor to hold a shareholder liable for corporate debt. After the debtor filed bankruptcy, the creditor sought to have the debt declared nondischargeable under section 523(a)(2)(A) as a debt "for money, property [or] services … to the extent obtained by … false pretenses, a false representation, or actual fraud." Actual fraud does not require a representation and is a ground for nondischargeability separate from false pretenses and false representation. An actual fraudulent transfer involves the transferor's actual fraud. The statute does not require that the property be obtained by the debtor; an actual fraudulent transfer's recipient might obtain the fraudulently transferred property by fraud if the recipient had the requisite intent. In any event, the statute does not apply only where the fraud occurred at the transaction's inception, and, since an actual fraudulent transfer comes within section 523(a)(2)(A)'s scope, the lower court must determine whether the debt was obtained by the asset-transfer scheme. *Husky Int'l Electronics, Inc. v. Ritz*, 578 U.S. ___, 136 S. Ct. 1581 (2016).

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 **Court of appeals lacks jurisdiction over appeal from order denying approval of a settlement.** The bankruptcy denied approval of a settlement of the estate's malpractice claim against the debtor's lawyers. The debtor appealed. The courts of appeals have jurisdiction over "appeals from all final decisions, judgments, orders, and decrees" issued by a district court or bankruptcy appellate panel reviewing a bankruptcy court decision. A final order disposes of the matter before the court and alters the status quo or fixes the rights and obligations of the parties. An order denying approval of a settlement does not change anything or fix any rights. Therefore, it is not a final order, and the court does not have jurisdiction over an appeal from the denial. *Church Joint Venture, L.P. v. Blasingame (In re Blasingame)*, ___ Fed. Appx. ___, 2016 U.S. App. LEXIS 10485 (6th Cir. 2016).

11.3.b **Appeal from settlement approval is not constitutionally moot if appellate court can fashion some relief.** A creditor won a judgment against the debtor for $23 million. The debtor appealed. Rather than posting a bond to stay execution pending the appeal, the debtor filed a chapter 7 petition. The trustee settled with the creditor: the creditor agreed to pay the estate $100,000, and the trustee agreed to allow the creditor's claim in the case for $23 million and to dismiss the appeal. Another creditor objected to the court's approval of the settlement but did not obtain a stay pending appeal. The trustee and the creditor consummated the settlement. An appeal is constitutionally moot if the appellate court cannot grant any effective relief. If the appellate court reversed the settlement approval, the trustee could not reinstate the dismissed appeal, but she could return the creditor's payment and the bankruptcy court could adjust the creditor's claim. Therefore, the appeal is not constitutionally moot. *Rich Dad Op. Co., LLC v. Zubrod (In re Rich Global, LLC)*, ___ F.3d ___, 2016 U.S. App. LEXIS 10933 (10th Cir. June 14, 2016).

11.3.c **Appeal from stay relief motion is constitutionally moot after foreclosure and dismissal of the chapter 11 case.** The bankruptcy court granted a secured creditor stay relief in the chapter 11 case to foreclose on the collateral. The debtor appealed the stay relief order. After the creditor completed foreclosure, the bankruptcy court dismissed the case. The debtor consented to and did not appeal the dismissal order. An appeal is constitutionally moot when the appellate court can no longer give the appellant any effective relief. Because the underlying bankruptcy case was dismissed and the dismissal order became final, reversal of the stay relief order would not re-impose the automatic stay. Therefore, the appellate court could not grant effective relief from the stay relief order. The appeal is moot. *Castaic P'ners II, LLC v. DACA-Castaic, LLC (In re Castaic P'ners II, LLC)*, ___ F.3d ___, 2016 U.S. App. LEXIS 9380 (9th Cir. 2016).

11.3.d **Ponzi scheme avoiding power defendant is not a person aggrieved by a substantive consolidation order.** The debtor conducted a Ponzi scheme through a parent company and several special purpose entity (SPE) subsidiaries. The trustee sued several SPE lenders as subsequent transferees to avoid and recover fraudulent transfers. While the actions were pending, the trustee moved for substantive consolidation of the parent and the SPEs, which the bankruptcy court granted. The lenders appealed. A party may appeal a bankruptcy court order only if the party is a "person aggrieved" by the order. A person is aggrieved if the order "diminishes the person's property, increases the person's burdens or impairs the person's rights." The harm must be direct. Harm that occurs only after several additional intervening steps does not qualify. Thus, a person is not a person aggrieved by an order that makes the person subject to litigation or that removes a potential defense. Here, the consolidation order effectively changed the lenders from subsequent transferees from the parent into initial transferees from the consolidated entities, reducing their defenses to the avoidance and recovery actions. Such an effect is indirect and insufficient to make the lenders persons aggrieved, so they do not have standing to appeal. *Opportunity Fin., LLC v. Kelley*, 822 F.3d 451 (8th Cir. 2016).

11.4 Sovereign Immunity

12. PROPERTY OF THE ESTATE

12.1 Property of the Estate

12.1.a **Under California law, directors' duties do not shift upon insolvency.** The liquidating trustee's complaint alleged that the closely held California debtor's directors used the debtor's assets to purchase interests in unrelated businesses for themselves, disregarded the debtor's deteriorating financial condition, failed to supervise business transactions so that the terms were deeply unfavorable to the debtor and failed to claim available tax refunds, all leading to the debtor's ultimate failure and substantial loss for the debtor and its creditors and shareholders. Under California law, a director owes duties of due care, loyalty and good faith. Based on recent California appellate court authority, the court concludes that California courts would follow Delaware law and general modern jurisprudence on interpretation of these duties: the duties and their beneficiaries do not change upon the corporation's insolvency, though creditors obtain standing to pursue claims against directors for breach of these duties if the corporation is insolvent. The trustee may bring them on behalf of creditors. The trustee adequately pleaded self-dealing and utter disregard of corporate duties. The defendants' motion to dismiss is denied as to most claims. *Solution Trust v. 2100 Grand LLC (In re AWTR Liquidation, Inc.)*, 548 B.R. 300 (Bankr. C.D. Cal. 2016).

12.2 Turnover

12.3 Sales

12.3.a **Second Circuit adopts "prepetition conduct plus prepetition contact or relationship" test for scope of sale free and clear order.** The debtor manufactured products with a serious defect, which it did not disclose. It filed a chapter 11 case, gave extensive publication notice and direct mail notice, but not direct mail notice to its customers who bought the product, and sold its assets under section 363 free and clear of all claims and interests. The product defect was revealed several years later, and people injured by the defect sued the buyer under a successor liability theory. Section 363(f)'s "free and clear" provision should be read in parallel with section 1141 to apply to claims and interests against the debtor that flow from the debtor's ownership of the sold assets to the same extent as under a plan confirmation order. A claim is subject to treatment in bankruptcy if it arose before the order cutting off the creditor's rights (sale order or confirmation order). For this purpose, a claim arises if it is a right to payment that "resulted from prepetition conduct fairly giving rise to the claim" as long as there is "some contact or relationship between the debtor and the claimant such that the claimant is identifiable" at the release date. Here, people injured before entry of the sale order were subject to the bar order. So were people who purchased the product before the sale order but were not injured until after, because they had a relation with the debtor, and their claims were contingent at the date of bankruptcy. Therefore, subject to due process compliance, the claims were subject to release. *Elliott v. General Motors LLC*, ___ F.3d ___, 2016 U.S. App. LEXIS 12848 (2d Cir. July 13, 2016).

12.3.b **Court may authorize sale of real property free and clear of an easement.** The debtor constructed a 15-story condominium tower that blocked an easement granted in 1920 in favor of adjacent property owners. Physical changes adjacent to the property rendered the easement effectively unusable. The debtor knew of the easement and brought litigation to have it declared void, but abandoned the litigation before its conclusion. The debtor proposed a plan to sell the property and the building free and clear of the easement to pay its secured lender. The lender agreed to a carve-out to pay the easement beneficiaries for their loss. One easment beneficiary objected to the sale free and clear. The beneficiary had an opportunity to litigate the easement's validity and obtain an injunction against the building before it was built but sat on his rights. Section 365(f)(5) permits a trustee to sell property free and clear of an interest if the interest holder may be compelled, in a legal or equitable proceeding, to accept a money satisfaction of the interest. An easement is an interest in property. Under applicable state law, an easement holder whose rights are violated can be compelled to accept a money satisfaction instead of an injunction directing removal of the obstruction based on the equities, such as the extent of impairment, the defendant's hardship in removing the obstruction, whether alternatives would afford more equitable relief and whether money damages would be a just and adequate remedy. Generally, equity will not require an encroacher to tear down a building unless the encroachment was willful and the violated property rights are substantial. In this case, preserving the easement would cause substantial harm to the debtor, the beneficiary's rights are not substantial, any benefit of the easement would be nominal and the beneficiary sat on his rights. Because, under state law, the beneficiary could be compelled to accept a money satisfaction, the plan may authorize the sale free and clear of the easement. *In re Metroplex on the Atlantic, LLC*, 545 B.R. 786 (Bankr. E.D.N.Y. 2016).

13. TRUSTEES, COMMITTEES, AND PROFESSIONALS

13.1 Trustees

13.2 Attorneys

13.3 Committees

13.4 Other Professionals

13.5 United States Trustee

14. TAXES

14.1.a **Tax foreclosure sale not based on a competitive auction might be avoidable as a fraudulent transfer.** The county auctioned the tax lien on the debtor's property under the 'interest rate method" of tax foreclosure. Under this method, potential buyers purchase only the tax lien, not the underlying property, and they bid only the interest rate they will charge the delinquent tax payer if it redeems from the tax lien within two years. Bidding is not based directly on the property's value. The buyer purchased the tax lien for the delinquent tax amount, which was between 4% and 8% of the property's value. The debtor failed to redeem, so the buyer obtained and recorded a tax deed to the property. Within two years after the buyer obtained the tax lien deed from the county, the debtor filed a chapter 13 case and sued to avoid the tax sale as a constructively fraudulent transfer. A chapter 13 debtor may avoid a transfer as constructively fraudulent if the transfer was made for less than reasonably equivalent value, while the debtor was insolvent and within two years before bankruptcy. Under *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), a regularly conducted mortgage foreclosure sale is deemed to be for reasonably equivalent value. *BFP*'s touchstone is the competitive auction for the property itself at the foreclosure sale. Here, there is no such auction, and the sale price has no particular relation to the property's value. Therefore, the *BFP* presumption does not apply. A purchase price of 4% to 8% of the property's value is not reasonably equivalent value. Therefore, the debtor may avoid the transfer. *Smith v. SIPI, LLC (In re Smith)*, 811 F.3d 228 (7th Cir. 2016).

15. CHAPTER 15—CROSS-BORDER INSOLVENCIES