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RECENT DEVELOPMENTS: FIFTH CIRCUIT COURT OF APPEALS AND UNITED STATES SUPREME COURT BANKRUPTCY DECISIONS

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1982-1982, Law Clerk to the Honorable James L. Dennis, Associate Justice, Louisiana Supreme Court, now Judge on United States Fifth Circuit Court of Appeals.
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APPEAL

Bullard v. Blue Hills Bank, 135 S.Ct. 1686 (U.S., May 4, 2015, **Justice Roberts)**

<u>Issue:</u> Whether a bankruptcy court's order denying confirmation of a proposed repayment plan with leave to amend is a "final" order that the debtor can immediately appeal.

A Chapter 13 debtor submitted a proposed repayment plan to the Bankruptcy Court. The mortgage lender objected. The Bankruptcy Court sustained the bank's objection and declined to confirm the plan. Debtor appealed to the First Circuit Bankruptcy Appellate Panel (BAP). The BAP concluded that the Bankruptcy Court's denial of confirmation was not a final, appealable order under 28 U.S.C. § 158(a)(1), but heard the appeal under a provision permitting interlocutory appeals with leave of the court under section 158(a)(3), and agreed with the Bankruptcy Court that the debtor's proposed plan was not allowed. Debtor appealed to the First Circuit, but it dismissed for lack of jurisdiction, concluding that its jurisdiction depended on the finality of the BAP's order, which in turn depended on the finality of the Bankruptcy Court's order. The First Circuit found that the Bankruptcy Court's order denying confirmation was not final so long as Bullard remained free to propose another plan.

In holding that a bankruptcy court's order denying confirmation of a debtor's proposed repayment plan is not a final order that the debtor can immediately appeal, the Supreme Court first found that Congress has long treated orders in bankruptcy cases as immediately appealable if they finally dispose of discrete disputes within the larger case. This approach is reflected in section 158(a) of Title 28, which provides that bankruptcy appeals as of right may be taken not only from final judgments in cases but from final judgments, orders, and decrees in cases and proceedings. Debtor argued that a bankruptcy court conducts a separate proceeding each time it reviews a proposed plan, and therefore a court's order either confirming or denying a plan terminates the proceeding and is final and immediately appealable. The Court disagreed, finding that the relevant proceeding is the entire process of attempting to arrive at an approved plan that would allow the bankruptcy case to move forward. Only plan confirmation, or case dismissal, alters the status quo and fixes the parties' rights and obligations; denial of confirmation with leave to amend changes little and can hardly be described as final.

Another factor that the Court found significant is that the statute defining core bankruptcy proceedings lists "confirmations of plans" in section 157(b)(2)(L) of Title 28, but omits any reference to denials. This bolsters the conclusion that the relevant proceeding is the entire process culminating in confirmation or dismissal. Another argument was that unless denial orders are final, a debtor would be required to choose between two untenable options: either accept dismissal of the case and then appeal, or propose an amended but unwanted plan and appeal its confirmation. The Court found that that prospect was made tolerable by the Court's confidence that bankruptcy courts rule correctly most of the time and by the existence of several mechanisms for interlocutory review. The Court therefore affirmed the decision of the First Circuit.

ATTORNEYS FEES

Baker Botts LLP v. Asarco LLC, 135 S.Ct. 2158 (U.S., June 15, 2015)

Issue: Whether the Bankruptcy Code permits bankruptcy courts to award attorney fees to counsel or other professionals employed by the bankruptcy estate for work performed in defending a fee application in court.

After confirming Chapter 11 plans for the debtor, the debtor's law firms filed fee applications, which drew objections. The bankruptcy court rejected the objections and awarded the law firms fees for time spent defending the applications. On appeal to the district court the awards were upheld. The Fifth Circuit reversed, holding that section 330(a)(1) did not authorize fee awards for defending fee applications.

In holding that section 330(a)(1) does not permit bankruptcy courts to award fees to section 327(a) professionals for defending fee applications, the Supreme Court first found that the so-called "American Rule" provides the basic point of reference for awards of attorney's fees - that each litigant pays his own attorney's fees, win or lose, unless a statute or contract provides otherwise. The Court does not deviate from such a rule absent explicit statutory authority. In this case, the Court found that Congress did not depart from the American Rule in section 330(a)(1) for fee-defense litigation. Section 330 authorizes "reasonable compensation for actual, necessary services rendered." The word services implies loyal and disinterested service in the interest of a client. Time spent litigating a fee application against the bankruptcy estate's administrator cannot be fairly described as labor performed for the client. Had Congress wished to shift the burdens of fee-defense litigation under section 330(a)(1), it could have done so, as it has done in other Bankruptcy Code provisions, such as section 110(i)(1)(C).

A dissenting opinion by Justices Breyer, Ginsburg and Kagan argued that the Bankruptcy Code affords courts broad discretion to decide what constitutes "reasonable compensation," and that compensation for fee-defense work is properly viewed as part of the compensation *for the underlying services* in a bankruptcy proceeding. When a bankruptcy court determines "reasonable compensation," it should be able to take into account the expenses that a professional has incurred in defending his or her application for fees.

***Newburger v. Texas Skyline* (Matter of Woerner),** 783 F.3d 266 (5th Cir., April 9, 2015, **En Banc - Judge Edward C. Prado)**

Issue: Whether fees may be awarded in bankruptcy cases under section 330 only when the fees provided, in hindsight, an identifiable, tangible, and material benefit to the bankruptcy estate.

Debtor filed a Chapter 11 bankruptcy case that was ultimately converted to Chapter 7. Debtor's counsel filed a fee application in the failed case for in excess of $130,000. The bankruptcy court allowed approximately $20,000 and disallowed the remainder, finding that the additional fees were unreasonable under the retrospective, "material benefit" standard previously enunciated by the Fifth Circuit in *Pro–Snax*. The district court affirmed. The law firm appealed, contending that the bankruptcy court misapplied Fifth Circuit precedent and section 330 in reducing the fees awarded to it. The Fifth Circuit Panel affirmed, and an appeal was taken En Banc.

The Fifth Circuit held that the retrospective, "material benefit" standard enunciated in *Pro–Snax* conflicts with the language and legislative history of section 330, diverges from the decisions of other circuits,

and has sown confusion in the Fifth Circuit. Correspondingly, the court overturned *Pro–Snax* 's attorney's-fee rule and adopted the prospective, "reasonably likely to benefit the estate" standard endorsed by sister circuits.

The court first found that the "hindsight" or "material benefit" standard enunciated in *Pro–Snax* conflicts with the text and legislative history of section 330 and unnecessarily places the Fifth Circuit at odds with sister circuits. Under section 330(a)(1)(A), an attorney who has been employed under sedtion 327 may request "reasonable compensation for actual, necessary services rendered." Section 330(a)(3) further directs courts to "consider the nature, the extent, and the value of" the legal services provided when determining the amount of reasonable compensation to award, "taking into account all relevant factors, including" . . . (C) whether the services were *necessary to the administration of, or beneficial at the time at which the service was rendered* toward the completion of, a case under this title. . . ." Further, section 330(a)(4) further lists those services for which a court may *not* approve compensation, and includes services that were not *reasonably likely to benefit the debtor's estate.*

In the Fifth Circuit's prior *Pro-Snax* case, the court adopted an approach of whether the services "*resulted* in an identifiable, tangible, and material benefit to the bankruptcy estate." The court rejected that approach, finding that the bankruptcy court's discretion is constrained by requiring the court to take into account a set of listed factors, including whether the services were necessary to the administration of, or beneficial *at the time at which the service was rendered* toward the completion of, a case under this title." The statute reinforces this point in an accompanying section: a court must disallow any compensation when the services "were not reasonably likely to benefit the debtor's estate or necessary to the administration of the case. Read together, a court may compensate an attorney for services that are "reasonably likely to benefit" the estate and adjudge that reasonableness "at the time at which the service was rendered." What matters is that, prospectively, the choice to pursue a course of action was reasonable.

The court further found that the Second, Third, and Ninth Circuits have rejected the actual-benefit test in favor of a prospective standard, The court therefore concluded that section 330 embraces the "reasonable at the time" standard for attorney compensation endorsed by the Second, Third, and Ninth Circuits.

CHAPTER 13

Harris v. Viegelahn, 135 S.Ct. 1829 (U.S., May 18, 2015, **Justice Ginsburg)**

<u>Issue:</u> Whether undistributed plan payments made by a debtor from his or her wages and held by the Chapter 13 trustee at the time of the case's conversion to Chapter 7 must be returned to the debtor or distributed to creditors.

After debtor's Chapter 13 case was converted to Chapter 7, debtor filed motion to compel Chapter 13 trustee to turn over undistributed funds that had been collected pursuant to confirmed Chapter 13 plan. The United States Bankruptcy Court for the Western District of Texas granted the motion, and trustee appealed. The District Court affirmed. Trustee appealed. The Fifth Circuit Court of Appeals reversed and remanded.

On appeal to the Supreme Court, the Court held that undistributed plan payments made by a debtor from his or her wages and held by the Chapter 13 trustee at the time of the case's conversion to Chapter 7 must be returned to the debtor, not distributed to creditors.

Individual debtors may seek discharge of their financial obligations under either Chapter 7 or Chapter 13 of the Bankruptcy Code. In a Chapter 7 proceeding, the debtor's assets are transferred to a bankruptcy estate, where the estate's assets are liquidatedand distributed to creditors. A Chapter 7 estate, however, does not include the wages a debtor earns or the assets he acquires *after* the bankruptcy filing under section 541(a)(1). Chapter 13, a wholly voluntary alternative to Chapter 7 permits the debtor to retain assets during bankruptcy subject to a court-approved plan for payment of his debts. Payments under a Chapter 13 plan are usually made from a debtor's "future income " under section 1322(a)(1). The Chapter 13 estate, unlike a Chapter 7 estate, therefore includes both the debtor's property at the time of his bankruptcy petition, and any assets he acquires after filing under section 1306(a). Because many debtors fail to complete a Chapter 13 plan successfully, Congress accorded debtors a non-waivable right to convert a Chapter 13 case to one under Chapter 7 at any time under secdtion 1307(a). Conversion does not commence a new bankruptcy case, but it does terminate the service of the Chapter 13 trustee, under section 348(e).

Debtor, indebted to multiple creditors and behind on his home mortgage payments, filed a Chapter 13 bankruptcy petition. His court-confirmed plan provided that money would be withheld from his postpetition wages and remitted to the Chapter 13 trustee for distribution to creditors. After failure of the plan, debtor converted the case to Chapter 7. Asserting that the Chapter 13 trustee lacked authority to disburse his postpetition wages to creditors postconversion, debtor sought an order from the Bankruptcy Court directing refund of the accumulated wages the trustee paid to his creditors. The Bankruptcy Court granted the debtor's motion, and the District Court affirmed. The Fifth Circuit reversed, concluding that a former Chapter 13 trustee must distribute a debtor's accumulated postpetition wages to his creditors.

On appeal to the Supreme Court, the Court reversed the Fifth Circuit and held that a debtor who converts to Chapter 7 is entitled to return of any postpetition wages not yet distributed by the Chapter 13 trustee. Absent a bad-faith conversion, section 348(f) limits a converted Chapter 7 estate to property belonging to the debtor "as of the date" the original Chapter 13 petition was filed. Because postpetition wages do not fit that bill, undistributed wages collected by a Chapter 13 trustee ordinarily do not become part of a converted Chapter 7 estate. By excluding postpetition wages from the converted Chapter 7 estate (absent a bad-faith conversion), section 348(f) removes those earnings from the pool of assets that may be liquidated and distributed to creditors. Allowing a terminated Chapter 13 trustee to disburse the very same earnings to the very same creditors is incompatible with that statutory design. The Court found that this conclusion is reinforced by section 348(e), which "terminates the service of the Chapter 13 trustee upon conversion. One service provided by a Chapter 13 trustee is disbursing "payments to creditors" under section 1326(c). The moment a case is converted from Chapter 13 to Chapter 7, a Chapter 13 trustee is stripped of authority to provide that "service."

Further, section 1327(a), which provides that a confirmed Chapter 13 plan binds the debtor and each creditor, and section 1326(a)(2), which instructs a trustee to distribute payments in accordance with the plan, cease to apply once the case is converted to Chapter 7. Finally, because Chapter 13 is a voluntary alternative to Chapter 7, a debtor's postconversion receipt of a fraction of the wages he earned and would have kept had he filed under Chapter 7 in the first place does not provide the debtor with a "windfall." A trustee who distributes payments regularly may have little or no accumulated wages to return, while a trustee who distributes payments infrequently may have a sizable refund to make. But creditors may gain

protection against the risk of excess accumulations in the hands of trustees by seeking to have a Chapter 13 plan include a schedule for regular disbursement of collected funds.

DISCHARGE

***Buescher v. First United Bank* (Matter of Buescher),** 783 F.3d 302 (5th Cir., April 13, 2015, **Judge Edith Brown Clement)**

Issue: Whether a bank was a creditor, and therefore had standing in a discharge action under section 727 of the Bankruptcy Code to sue a debtor-wife who did not join her husband in guaranteeing the debt of her husband's limited partnership to a bank.

Debtor/husband operated a home-building business. His wife, a Texas-licensed attorney, often served as the closing officer for real estate transactions. Bank loaned the business approximately $19 million. Debtor Husband personally guaranteed the bank's loans, but his wife did not. Debtors filed a joint Chapter 7 bankruptcy petition. The bank filed an adversary complaint arguing, *inter alia,* that the bankruptcy court should refuse to discharge both husband and wife from the bankruptcy action under sections 727(a)(2)-(5). The bankruptcy court entered a final judgment denying a discharge to both the husband and wife debtors. The district court affirmed the judgment of the bankruptcy court.

On appeal to the Fifth Circuit, the debtor/wife argued that the bank did not have standing to object to her discharge, because it was not her creditor under section 727(c)(1), which provides that the trustee, a creditor, or the United States trustee may object to the granting of a discharge. The Fifth Circuit disagreed, holding that the bank was the wife's creditor under section 727(c)(1). Wife never personally guaranteed the loans the bank made. Thus the court said that she was not *personally* liable to the bank. However, Texas is a community property state, and under Texas law, the bank has an *in rem* claim against any community property that the debtor/husband jointly held with his wife. Because husband and wife have jointly-held community property, the bank could seek repayment in Texas court through an *in rem* suit against the wife.

The court further found that the Bankruptcy Code defines "creditor" to include an "entity that has a community claim." It defines "community claim" as a claim "for which property of the kind specified in section 541(a)(2) of this title is liable." Section 541(a)(2) provides that a bankruptcy estate includes "[a]ll interests of the debtor and the debtor's spouse in community property" that is either "(A) under the sole, equal, or joint management and control of the debtor;" or "(B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable." Read together, these provisions show that an entity that holds a claim against the nondebtor spouse under state law but does not hold a claim against the debtor, may nonetheless be considered a 'creditor' of the debtor so long as that claimant could, under state law, satisfy the claim from community property of the type which would have passed to the estate. Because the bank could satisfy its claim against husband through an *in rem* suit against the wife, the bank was the wife's creditor under section 727(c)(1). Accordingly, the Fifth Circuit found that the bankruptcy court did not err by holding that the bank had standing to object to the wife's discharge.

EXCEPTIONS TO DISCHARGE

Husky Intl. Electronics, Inc. v. Ritz (In re

Ritz), 787 F.3d 312 (5th Cir. 2015, **Judge King**).

<u>Issue:</u> Whether a representation is a necessary prerequisite for a showing of "actual fraud" under the Section 523(a)(2)(A) discharge exception for debts obtained by false pretenses, a false representation, or actual fraud.

Debtor was principal of Chrysalis Manufacturing Corp., which purchased electronic device components from Husky International Electronics, Inc. pursuant to a written contract. During his financial management of Chrysalis, the Debtor caused Chrysalis to transfer significant amounts of assets to affiliated entities, also controlled by the Debtor, without receiving reasonably equivalent value, and the Bankruptcy Court found that, at all relevant times, Chrysalis's total liabilities exceeded its assets and Chrysalis was not paying its debts as they came due. Husky sued the Debtor in federal district court to hold Debtor personally liable for the outstanding Chrysalis debt. The Debtor filed a voluntary chapter 7 petition a few months thereafter, and Husky timely filed an objection to the Debtor's discharge of Husky's debt under Sections 523(a)(2)(A), (a)(4), and (a)(6). The Bankruptcy Court first addressed whether the Debtor could be held liable for Chrysalis's debt under Texas veil-piercing laws and found that Husky had failed to establish that Debtor perpetuated an actual fraud on Husky, a prerequisite for piercing the veil under Texas law, because Husky could not show that Debtor made a false representation to Husky. On this basis, the Bankruptcy Court also found that the 523(a)(2)(A) exception to discharge did not apply since it also required an actual false representation by the Debtor. The Bankruptcy Court also found Sections 523(a)(4) and (6) inapplicable. The District Court affirmed.

On appeal, the Fifth Circuit found that a representation is a necessary prerequisite for a showing of "actual fraud" under Section 523(a)(2)(A). Declining to follow a contradictory Seventh Circuit opinion finding that actual fraud under 523(a)(2)(A) is not limited to misrepresentations and misleading omissions, the Fifth Circuit reasoned that the Supreme Court's opinion in *Field v. Mans*, 516 U.S. 59 (1995), appears to assume that a false representation is necessary to actual fraud. The Fifth Circuit found that *Field* makes clear that the meaning of "actual fraud" depends on the common law meaning of the term in 1978 when the language was added to 523(a)(2)(A). Furthermore, the expansive definition of actual fraud proposed by Husky would directly contradict prior Fifth Circuit authority explicitly requiring proof of a debtor's false representation in order to support nondischargeability under an actual fraud theory and would render other exceptions to discharge redundant, including the exception under 523(a)(4) for debts for fraud or defalcation while in a fiduciary capacity and under 523(a)(6) for debts for willful and malicious injury by the debtor. Since the parties agreed that there was no evidence of such a representation, discharge of the debt was not barred under 523(a)(2)(A).

As an alternative argument, Husky argued that the Bankruptcy Courts should exercise its equitable power to except Husky's debt from discharge and prevent the Bankruptcy Code from becoming an engine of fraud. The Fifth Circuit rejected this argument as well, reasoning that the Bankruptcy Courts may only exercise their equitable powers in a manner that is consistent with the Bankruptcy Code and may not create substantive rights that are otherwise unavailable under applicable law or "constitute a roving commission to do equity," citing *Perkins Coie v. Sadkin*, 46 F.3d 473, 478 (5th Cir. 1994).

DISMISSAL

***Kelley v. Cypress Financial Trading Co., LP* (Matter of Cypress Financial Trading Co.,**

LP), 2015 WL 4747363 (5th Cir., August 12, 2015)

Issue: Whether there is "cause," under section 707(a), to dismiss a Chapter 7 bankruptcy case where the bankruptcy serves no purpose, results in no benefit for its creditors or the debtor, and only delays litigation already pending against the debtor.

A Chapter 11 trustee for an entity that had operated a Ponzi scheme prepetition sued an investor, seeking recovery of funds that the investor and its partners had received from the Ponzi scheme. After fighting the lawsuit brought by the trustee for some time, the investor/debtor sought Chapter 7 relief. The trustee of the entity that had operated the Ponzi scheme filed motion to dismiss the investor/debtor's Chapter 7 case. The United States Bankruptcy Court for the Northern District of Texas denied the motion, and trustee appealed. The District Court reversed and remanded. The investor/debtor appealed to the Fifth Circuit.

The Fifth Circuit found that a corporate Chapter 7 bankruptcy has one purpose: to allow an entity breathing space to marshal assets for orderly distribution to creditors. When, as here, the debtor has no assets, no viable claims or causes of action, and no other money-making prospects, Chapter 7 bankruptcy cannot serve even this limited function. Under section 707(a), "cause" to dismiss exists when bankruptcy cannot benefit outside creditors or the debtor and the process serves only to delay the prosecution of a lawsuit against the debtor. Section 707 does not define "cause," but instead provides a list of examples, like the debtor's unreasonable delay of the proceedings, failure to pay required fees, or untimely filing of schedules and financial statements. The examples, however, are illustrative, not exhaustive. "Cause" is a broad concept, designed to "afford flexibility to the bankruptcy courts." This flexibility derives from bankruptcy's equitable roots.

The court found that the equities of this case favored dismissal, including cost and delay with absolutely no resulting benefit to the debtor or its creditors. There is no hope of discharge or a fresh start here, because a discharge is unavailable to corporate debtors in Chapter 7 cases. A corporate Chapter 7 (and the resulting automatic stay) may allow breathing space for a neutral third party to marshal assets for orderly distribution to creditors. But again, there was no hope of that here because there were no assets to marshal or liquidate, and applicable statutes of limitations would bar any preference or fraudulent transfer actions that might lead to additional assets. Without any conceivable benefit to the debtor or creditors, a bankruptcy loses its *raison d'etre,* compelling a dismissal.

JURISDICTION

Wellness Int'l Network, LTD v. Sharif, 135 S.Ct. 1932 (U.S., May 26, 2015, **Justice Sotomayor)**

Issue: Whether Article III permits bankruptcy courts to adjudicate *Stern* claims, that is, claims designated for final adjudication in the bankruptcy court as a statutory matter but prohibited from proceeding in that way as a constitutional matter, with the parties' knowing and voluntary consent.

An adversary proceeding against a debtor sought both a determination of the dischargeability of the debt and a declaratory judgment from the Bankruptcy Court contending that a trust was in fact the debtor's alter-ego, and that its assets were his personal property and part of his bankruptcy estate. The Bankruptcy Court eventually entered a default judgment against the debtor. While the debtor's appeal was pending in District Court, but before

briefing concluded, this Supreme Court in *Stern v. Marshall* held that Article III forbids bankruptcy courts to enter a final judgment on claims that seek only to "augment" the bankruptcy estate and would otherwise exist without regard to any bankruptcy proceeding. After briefing closed, the debtor sought permission to file a supplemental brief raising a *Stern* objection. The District Court denied the motion, finding it untimely, and affirmed the Bankruptcy Court's judgment. The Seventh Circuit Court of Appeals determined that the debtor's *Stern* objection could not be waived because it implicated structural interests and reversed on the alter-ego claim, holding that the Bankruptcy Court lacked constitutional authority to enter final judgment on that claim.

On appeal to the Supreme Court, the issue was whether Article III permits bankruptcy judges to adjudicate *Stern* claims with the parties' knowing and voluntary consent. The Supreme Court has previously held in is *Commodity Futures Trading Comm'n v. Schor* that the right to adjudication before an Article III court is personal and therefore subject to waiver. The importance of consent was has been reiterated in two later cases involving the Federal Magistrates Act's assignment of non-Article III magistrate judges. The Court stated that the question of whether allowing bankruptcy courts to decide *Stern* claims by consent would impermissibly threaten the institutional integrity of the Judicial Branch needed to be decided with an eye to the practical effect that the practice would have on the constitutionally assigned role of the federal judiciary. Here, the decision to invoke the bankruptcy court's authority is left entirely to the parties and the power of the federal judiciary to take jurisdiction remains in place. The Court found that *Stern* did not compel a different result.

The Court next held that consent to adjudication by a bankruptcy court need not be express, but must be knowing and voluntary. Neither the Constitution nor the relevant statute mandates express consent. Such a requirement would be in great tension with the Court's holding that substantially similar language in the statute authorizing magistrate judges to conduct proceedings upon consent of the parties permits waiver based on actions rather than words. The implied consent standard supplies the appropriate rule for bankruptcy court adjudications and makes clear that a litigant's consent—whether express or implied—must be knowing and voluntary. The Court therefore reversed and remanded the Seventh Circuit's decision.

LIENS

Bank of America v. Caulkett, 135 S.Ct. 1995 (U.S., June 1, 2015, **Justice Thomas)**

Issue: Whether section 506(de), providing that a lien is void to the extent that it secures a claim against the debtor that is not an allowed secured claim, may be utilized to "strip off" a junior mortgage lien that is wholly unsupported by any equity in mortgaged property.

Debtors filed for Chapter 7 bankruptcy, and owned houses encumbered with a senior mortgage that exceeded the value of the property, leaving junior mortgage liens wholly underwater. The debtors sought to void their junior mortgage liens under section 506(d), which provides, "To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void." The Bankruptcy Courts granted the motion, and both the District Court and the Eleventh Circuit affirmed.

The Supreme Court held that a debtor in a Chapter 7 bankruptcy proceeding may not void a junior mortgage lien under section 506(d) when the debt owed on a senior mortgage lien exceeds the current value of the collateral if the

creditor's claim is both secured by a lien and allowed. The Court found that the only way that the debtors could prevail is if the bank's claims were not allowed secured claims. The Court found that it was undisputed that the bank's claims were, in fact, "allowed" under the Code. Instead, the debtors argued that the bank's claims were not "secured." The Court found that its prior case of *Dewsnup* concluded that an allowed claim secured by a lien with recourse to the underlying collateral does not come within the scope of section 506(d). Therefore, under *Dewsnup,* a "secured claim" is a claim supported by a security interest in property, regardless of whether the value of that property would be sufficient to cover the claim.

PROPERTY OF THE ESTATE

Cantu v. Schmidt, 784 F.3d 253 (5th Cir., April 16, 2015, **Judge Gregg Costa)**

Issue: Whether a cause of action accrued pre-conversion, such that the action would be property of the estate, or accrued post-conversion, such that the action would be property of the individual debtors.

After debtors' bankruptcy was converted from a chapter 11 reorganization to a chapter 7 liquidation, debtors sued their bankruptcy attorney for malpractice prior to the conversion of the case. The chapter 7 trustee intervened in the action, contending that the claims belonged to the estate. The parties eventually settled the malpractice case and the funds were deposited into the court registry pending a determination whether the settlement proceeds belonged to the debtors individually or to the bankruptcy estate. The Fifth Circuit found that the resolution of that question depended on timing. If the causes of action against the attorney arose before conversion of the bankruptcy to a chapter 7, the settlement belonged to the estate; otherwise, to the debtors. The bankruptcy court held that the proceeds belonged to the estate, and the district court affirmed.

On appeal to the Fifth Circuit, the court first found that the property of a chapter 11 bankruptcy estate under section 541(a)(1) includes "all legal or equitable interests of the debtor in property as of the commencement of the case." A 2005 amendment to the Bankruptcy Code (section 1115(a)(1)) expanded that definition for individual chapter 11 debtors to encompass "all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is ... converted to a case under Chapter 7. Causes of action that belong to the debtor "at the time the case is commenced" or that are acquired after commencement but before conversion are therefore property belonging to the estate. But if a cause of action is acquired at or after the time of conversion, it belongs to the individual debtor.

When a cause of action arises is a matter of accrual. As is often the case under tort law, wrongful conduct alone is not sufficient for accrual of the negligence and fiduciary duty claims - some form of legal injury must have occurred before these causes of action accrued. The Fifth Circuit Court turned to the more difficult task in this case: applying the accrual approach. The court stated that the accrual of a cause of action means the right to institute and maintain a suit, and whenever one person may sue another a cause of action has accrued. The parties agree that the attorney's misconduct in handling the bankruptcy occurred pre-conversion. However, under state law most causes of action do not accrue until the wrongful act caused an injury. Debtors argued in this case that necessary injury occurred only after conversion when their assets were liquidated and the bankruptcy court denied them discharge. The trustee acknowledged that this injured the debtors as they were still liable for their debts. But he argued that the estate also suffered injuries from the attorney misconduct, and those injuries arose earlier, prior to the conversion.

The general rule is that a cause of action accrues when a wrongful act causes *some* legal injury, even if the fact of injury is not discovered until later, and *even if all resulting damages have not yet occurred.*"

As for the conduct that gave rise to these causes of action, the debtors alleged that the attorney failed to timely request permission for use of cash collateral, failed to schedule certain transfers of assets, employed an incompetent associate, failed to inform one of the debtors' witnesses when he would testify, failed to prepare the expert, and failed to file a confirmable plan of reorganization. They further contended that the attorney misrepresented her experience in complex bankruptcy cases. The bankruptcy court agreed with these allegations, finding systemic malpractice in concluding that the attorney's conduct was "so egregious and so outside the bounds of acceptable, professional conduct of a fiduciary that (at some point well before the conversion) the acts created 'a specific and concrete risk of harm' to the debtors' interests sufficient to constitute legally cognizable injury."

In reviewing that accrual determination, the Fifth Circuit focused on whether the allegations and causes of action in the debtors' petition injured the estate in a manner that would have enabled the trustee to file the lawsuit prior to conversion. They concluded that the attorney's misconduct injured the creditor body in a number of ways during the pendency of the chapter 11 bankruptcy that would have allowed the estate to file suit prior to conversion. The court found that the fact that the creditors were injured by the attorneys actions, and that this injury occurred prior to conversion, meant that the cause of action accrued pre-conversion, and was therefore property of the estate. The Fifth Circuit therefore affirmed the district court.

TRUSTEES

***Smith v. Robbins* (Matter of IFS Financial Corp.),** 2015 WL 5672114 (5th Cir., September 25, 2015, **Judge Patrick E. Higgonbotham)**

<u>Issue</u>: Whether the bankruptcy court erred in removing a Chapter 7 trustee for cause from a case (under section 324(a)) and all of the trustee's other cases (under section 324(b)) where the trustee charged the bankruptcy estate for travelling to an oral appellate argument three days early, staying the night afterward, and later submitting a large un-itemized bill to the estate.

A Chapter 7 trustee, his lead appellate attorney, and wife and their two children traveled to New Orleans for an oral argument. They arrived three days early and stayed the night afterwards. The trustee later submitted a large, unitemized bill for his firm's work that included a request to distribute $3,486.37 in estate funds to his firm for trip expenses. After receiving an objection from a creditor, the trustee filed an itemized invoice, including expenses for a hotel stay at $359 per night, charges for room service and the coach portion of airfare.

The bankruptcy court disallowed much of the requested amount and ordered the trustee to show why he should not be removed as trustee under section 324 of the Bankruptcy Code. After a hearing, the court removed the trustee, in part because his *prior* conduct in other cases convinced it that his conduct in this case was intentional. The court stated that "no reasonable fiduciary would accept a bill from its Counsel for the Saturday night or the Tuesday night's stays." "He intentionally charged the estate ... for substantial expenses incurred for his personal benefit. He did not challenge those in his capacity as Trustee and that was a willful breach as his duty as a Trustee...." Under section 324(b), the trustee was also removed in all of his other pending cases. The district court affirmed.

On appeal to the Fifth Circuit, the trustee argued that the bankruptcy court abused its

discretion in removing him, as did the district court in affirming the removal. Trustee argued that he lacked adequate notice and that the court lacked sufficient cause to remove him. The Fifth Circuit disagreed. With respect to notice, the court found that notice must be specific enough to allow the parties to prepare and respond to the noticed issue. The court found that it was undisputed that the trustee had notice that he might be removed because of his conduct regarding the New Orleans trip expenses—that conduct was described in detail in the Show Cause order—and that he had a hearing. The court found that the notice here was sufficient.

With respect to the "cause" issue, the court found that the bankruptcy court considered undisputed evidence that the trustee charged the estate over $3,000 for the New Orleans trip, that he failed to itemize in his distribution request, and that he provided the necessary detail only days before the hearing on a creditor's objections. At the hearing on the objections, he was not forthcoming with the fact that his children accompanied him and his wife on the New Orleans trip. In light of these facts, the bankruptcy court found that the trustee "willfully breached his fiduciary duty to the Estate" and that he intended that the charges would not be scrutinized. The court also concluded that no reasonable person, or fiduciary, would allow charges against the estate for at least two of the nights in New Orleans. The court ruled that these findings amounted to clear and convincing evidence of "cause" and justified the trustee's removal. The Fifth Circuit found that it could not conclude that the bankruptcy court thereby abused its discretion, or that the district court clearly erred in affirming the ruling.

The trustee further argued that a simple breach of fiduciary duty, without something more, was legally insufficient "cause" for removal under section 324, and that actual injury or fraud were required. The court disagreed, finding that "cause" under section 324(a) is not defined in the Bankruptcy Code or in Fifth Circuit precedent. However, undefined terms in the Bankruptcy Code are to be given their ordinary meaning. They also noted that the phrase "for cause" in two *other* Bankruptcy Code provisions is "not defined in the statute so as to afford flexibility to the bankruptcy courts." Without adopting a general interpretation of the term "cause" under section 324(a), the court was persuaded that the trustee's conduct, as determined by the bankruptcy court, justified removal regardless of whether it entailed gross negligence or "actual injury or fraud."

Finally, the Fifth Circuit found that section 324(a) is not facially unconstitutional, and that it was not unconstitutionally applied. The court therefore affirmed the district and bankruptcy courts.

Villegas v. Schmidt, 788 F.3d 156 (5th Cir., May 28, 2015, **Judge Leslie H. Southwick)**

Issue: Whether the Supreme Court in *Stern v. Marshall* effectively created an exception to the *Barton* doctrine.

Issue: Whether the *Barton* doctrine does not apply when a party brings suit in the district court that exercises supervisory authority over the bankruptcy court that appointed the trustee.

A limited liability company and its president brought action against a bankruptcy trustee allegeding that the trustee committed gross negligence and breached his fiduciary duty while acting as trustee of the debtor by failing to pursue an action against an insurance company. They asserted that the insurance company had issued an insurance policy worth $10 million to the debtor, which would have covered many of the creditors' claims against it. The district court dismissed the case on the trustee's motion because the plaintiffs failed to obtain leave from the bankruptcy court that appointed the bankruptcy trustee before filing suit against him. The plaintiffs appealed.

On appeal to the Fifth Circuit, the plaintiffs argued that what has become known as the *Barton* doctrine does not apply in this case for two reasons. First, they contend that the Supreme Court in *Stern v. Marshall* effectively created an exception to the *Barton* doctrine. Second, they argued that the *Barton* doctrine does not apply when a party brings suit in the district court that exercises supervisory authority over the bankruptcy court that appointed the trustee.

The Fifth Circuit disagreed, concluding that the *Barton* doctrine continues to apply regardless of whether the plaintiffs' claims qualify as *Stern* claims, for two reasons. First, the Supreme Court has directed appeals courts to abstain from concluding that one of the Court's later cases has, by implication, limited or overruled one of its earlier cases. Second, the Court has recently suggested that *Stern* would not, in fact, limit the *Barton* doctrine when it stated that "*Stern* did not ... decide how bankruptcy or district courts should proceed when a *'Stern* claim' is identified." The court found that they were not called upon in this case to provide all the details regarding how a party should, post-*Stern,* proceed under *Barton.* They were only holding that a party must continue to file with the relevant bankruptcy court for permission to proceed with a claim against the trustee. If a bankruptcy court concludes that the claim against a trustee is one that the court would not itself be able to resolve under *Stern,* that court could then make the initial decision on the procedure to follow. Once a bankruptcy court makes such a determination, this court can review the utilized procedure.

Regarding the second argument, the plaintiffs argued that the Ninth Circuit has held that the *Barton* doctrine does not apply when a case against a trustee is removed from state court to the appointing bankruptcy court. The court reasoned that the appointing court could not invoke *Barton* because the doctrine "denies subject matter jurisdiction to all forums *except* the appointing court." *Id.* However, the Fifth Circuit found that nothing in that opinion suggests that "appointing court" should be construed to include the court with supervisory authority over the appointing court. Additionally, every other circuit to address the issue has maintained the distinction between the bankruptcy court and the district court, holding that "a debtor must obtain leave of the bankruptcy court before initiating an action in district court when the action is against the trustee or other bankruptcy-court-appointed officer, for acts done in the actor's official capacity." The court therefore affirmed the dismissal of the case.