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IN THIS ISSUE

Court Denies Confirmation of Competing Plans Proposed by Debtor and Creditors' Committee

District Court Upheld Assignment of § 544(b) Claims in Bankruptcy Stipulation

Eighth Circuit: Bankruptcy Court Cannot Substantively Consolidate Debtor with Non-Debtor Non-Profit Entities

Debtor's False Oral Statement About a Single Asset Does Not Preclude Discharge of Debt

The Eighth Circuit Determines Whether There is an Agreement for Attorneys' Fees under 11 U.S.C. § 506(b) and Whether an Untimely Request for the Same under a Chapter 11 Plan is a Material Breach

Homestead Sale Proceeds Do Not Lose Exempt Status During Pendency of Bankruptcy Case

The Eighth Circuit Holds Again That a Minnesota Property Tax Refund is Not Government Assistance Based on Need and Not Exempt under Minn. Stat. § 550.37, Subd. 14.

Court Denies Confirmation of Competing Plans Proposed by Debtor and Creditors' Committee

In two orders and a joint memorandum, the bankruptcy court denied confirmation of competing plans proposed by the committee of unsecured creditors and the debtor in *In re The Archdiocese of Saint Paul and Minneapolis*, Case No. 15-30125 (Bankr. D. Minn. Dec. 28, 2017). In the process, the court directed the parties to return to mediation, decided whether liability insurance proceeds and parish contributions belong to the bankruptcy estate, decided whether indemnity claims can be disallowed or discharged, and established criteria for confirming a plan that provides for discharge of claims against non-debtor third parties, among other issues.

In the joint memorandum, the court took notice of the intense impact of this case on people in light of hundreds of proofs of claim describing sexual abuse by priests and costs that will fall on current employees, students at Catholic schools, parishioners, and other innocent persons. The court also questioned whether a one third contingency fee is appropriate for completing proofs of claim. Most significantly, the court reminded the parties that a resolution would require agreement among all constituencies.

<u>The Committee's Proposed Plan</u>

The court sustained objections based on failure to provide for all claims in the committee's proposed plan, including mortgages secured by real estate owned by the debtor for loans taken out by two Catholic high schools. The court held that a security interest qualifies as a claim that must be provided for by the plan even if the debtor is not personally liable. Also, the proposed plan failed to provide for contingent indemnification and contribution claims by the parishes. The proposed plan provided that contingent contribution claims would be disallowed pursuant to 11 U.S.C. § 502(e)(1)(B), but the committee did not formally object to the claims. Because § 502(a) states that a claim is deemed allowed unless an interested party objects, the contingent contribution claims were allowed and must be provided for in a confirmable plan.

For similar reasons, the court sustained objections that the proposed plan improperly designated various claims, including claims for support and maintenance of credibly accused priests, as unimpaired based on a proposal to disclaim the liability under civil law.

The court sustained the parishes' objections that the plan cannot transfer insurance proceeds to a trust without the consent of the parishes because Minnesota law restricts an insurer's ability to transfer or release a policy if there are known claims against the insured that would remain unsatisfied due to the insured's financial condition. For similar reasons, the court sustained objections that the proposed plan violated Minnesota law because it would transfer interests in worker's compensation and medical insurance proceeds to the trust.

The court also held that the insurance proceeds could not be transferred without the consent of other constituents with interests in the proceeds. For example, the proceeds may belong to officers and directors if the policies are meant to protect the officers and directors from claims made against them personally. Even if the policies and proceeds belong to the estate, anti-assignment clauses may prevent assigning insurance proceeds to a trust absent the insurer's consent. And, the debtor may hold bare legal title for the benefit of a non-debtor, including possible tort claimants.

The court also sustained feasibility objections without an evidentiary hearing even though feasibility is typically a fact issue. Because the committee's proposed plan would require the debtor to obtain financing to fund the plan, but failed to demonstrate that obtaining financing was likely, the plan was unfeasible on its face. In addition, the plan was unfeasible because it depended on proceeds from future litigation, which is speculative and uncertain. Finally, the plan was unfeasible because it relied on fundraising, which is speculative and may be hampered by the unwillingness of charitable donors to pay off judgment or tort creditors.

The court sustained objections to the committee's proposal to fund the plan partly from increased parish assessments because the debtor cannot be legally compelled to levy assessments against the parishes and the parishes cannot be legally compelled to pay assessments.

The court sustained objections of unfair discrimination between pending and future tort claimants, but overruled objections of unfair discrimination between holders of guaranties and between holders of claims for contribution and indemnification. Because the plan did not provide a basis for discriminating between pending and future tort claimants, the court held that the proposed plan failed to satisfy the four-part test: (1) whether the discrimination is supported by a reasonable basis; (2) whether the debtor can confirm and consummate a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) the treatment of the classes discriminated against. On the other hand, because contingent indemnification claims may be disallowed under § 502(e), disparate treatment between holders of indemnification claims and holders of guaranty claims is not unfair discrimination.

The court overruled objections that the proposed plan called for advisory opinions regarding the legality of using insurance proceeds to fund the plan, among other issues. To the contrary, the court held that an objection to plan confirmation is a case or controversy that requires resolution of the issues as part of the plan confirmation process.

Because the proposed plan would likely result in extended litigation about more than a dozen issues, the court held that it would unnecessarily prolong the bankruptcy case and waste estate resources.

Finally, the court held that the committee's proposed plan failed to provide adequate means for its implementation, as required by § 1123(a)(5), because of the speculative sources of funding and reliance on proceeds from future litigation.

The Debtor's Proposed Plan

The court sustained an objection that the debtor's proposed plan failed to provide for claims for medical expenses, lost wages, or other damage claims that may be asserted by trustees for deceased tort claimants. The court next repeated its analysis of issues that overlapped with the committee's proposed plan.

Significantly, the court considered what appears to be an issue of first impression in the Eighth Circuit: whether the proposed plan improperly purported to release claims against non-debtor third parties. The court surveyed the case law nationally, including divergent views among ten different Circuit Courts of Appeals. Based on the law in other jurisdictions, the court formulated four criteria: (1) large or numerous liabilities against the debtor and the co-liable parties to be released, (2) a substantial contribution from the non-debtor co-liable parties, (3) the importance of the third party releases to the reorganization process, and (4) significant acceptance of the plan by the group of creditors who are being asked to give up their claims against the non-debtor co-liable parties. The court sustained the objection based on the number of tort-claimants who had rejected the plan.

Finally, the court over-ruled objections that the plan was proposed in bad faith because mere disagreements between the debtor and the committee do not equate bad faith.

http://my.mnbar.org/blogs/karl-johnson/2018/06/28/court-denies-confirmation-of-competing-plans-propo

District Court Upheld Assignment of §544(b) Claims in Bankruptcy Stipulation

Plaintiffs sued the debtor for fraud related to a Cedar Rapids hotel development in 2009 and obtained a judgment in 2012. While the litigation was pending in Iowa state court, however, the debtor's net worth decreased by over $5.4 million and plaintiffs were unsuccessful in collecting the judgment. They responded by commencing a fraudulent transfer action in the U.S. District Court for the District of Minnesota against the debtor's wife, daughter, and son-in-law (the "Fraudulent Transfer Litigation").

Faced with contempt proceedings in the Fraudulent Transfer Litigation, the debtor filed a chapter 7 bankruptcy petition. The bankruptcy trustee was substituted for the plaintiffs in the Fraudulent Transfer Litigation pursuant to § 544(b). Plaintiffs and the trustee entered into a stipulation pursuant to which the debtor's daughter and son-in-law paid $200,000 to the estate in exchange for releases. Plaintiffs received $100k, and the estate retained $100k of the proceeds. Under the stipulation, plaintiffs gave up any right to receive a distribution from the estate and the trustee assigned all remaining causes of action in the Fraudulent Transfer Litigation back to plaintiffs. No objections were filed and the stipulation was approved by the bankruptcy court in 2017.

In accordance with the stipulation, Plaintiffs were substituted back into the Fraudulent Transfer Litigation, the claims against the debtor's daughter and son-in-law were dismissed but the claims against his wife went forward. Plaintiffs amended the complaint to name the debtor and several companies controlled by him as additional defendants. The complaint, as amended, alleged defendants engaged in an extensive pattern of actual and constructive fraudulent transfers. Defendants moved to dismiss on several grounds, including, without limitation, that plaintiffs lacked standing because the trustee's assignment was invalid. More specifically, defendants argued: (1) a bankruptcy trustee cannot assign its "avoidance powers" under the Code; and (2) the claims set forth in the complaint were not property of the estate (and therefore cannot be assigned by the bankruptcy trustee). The district court considered and rejected both of defendants' theories.

In connection with defendants' first argument, the district court noted the distinction between avoidance powers created by the Code (e.g., § 547 or § 548), versus the trustee's power under § 544(b) "to step into the shoes of a creditor and bring claims under state law." Because the Fraudulent Transfer Litigation here is predicated on § 544(b) claims, and not powers of the trustee under the Code, the district court rejected defendants' theory that the stipulation was an impermissible assignment of the trustee's powers under the Code.

Second, the district court considered and rejected defendants' theory that the fraudulent transfer claims in this case were not property of the estate. The district court acknowledged the existence of a circuit split, but ultimately adopted the majority view that § 544(b) claims are property of the estate. The district court also noted that courts are divided as to whether a trustee may transfer avoidance claims. The court was persuaded by the fact that this case involved a transfer of pre-existing § 544b claims from the trustee back to creditors. The district court also noted that the Eighth Circuit has permitted creditors to pursue claims created by the Code upon a showing that the trustee cannot be relied upon to assert them, or that creditors can be granted derivative standing to pursue such claims when it is "necessary and beneficial to the fair and equitable resolution" of a bankruptcy case. Because an assignment "confers greater rights," however, the district court indicated that any assignment of § 544(b) claims must also be "necessary and beneficial" to the estate. The court reviewed the record below, including the trustee's statements in the motion to approve the stipulation, and decided that such standard was satisfied in this case because the stipulation reduced fees and burden to the estate, reduced the claims pool, and streamlined overall resolution of the case.

http://my.mnbar.org/blogs/karl-johnson/2018/07/17/district-court-upheld-assignment-of-544b-claims-in

Eighth Circuit: Bankruptcy Court Cannot Substantively Consolidate Debtor with Non-Debtor Non-Profit Entities

In *The Official Committee of Unsecured Creditors v. The Archdiocese of St. Paul and Minneapolis, et al. (In re The Archdiocese of St. Paul and Minneapolis)*, 888 F.3d 944 (8th Cir. Apr. 26, 2018), the Eighth Circuit affirmed denial of the Creditors' Committee's motion seeking substantive consolidation of more than 200 affiliated non-profit non-debtor entities with the debtor because, among other reasons, substantive consolidation would have required the commencement of involuntary bankruptcy proceedings.

The Committee, representing more than 400 clergy sexual abuse victims, argued that the non-debtor entities should be consolidated because they were directly controlled and supervised "in all material aspects" by the debtor, including "the oversight of financial and property-related decision-making." Consolidation would have allowed the Committee to combine the debtor's and the non-debtor entities' assets to satisfy creditors. The Committee's asserted legal basis for substantive consolidation was 11 U.S.C. § 105(a), which gives bankruptcy courts the power to "carry out the provisions of the Bankruptcy Code." The Eighth Circuit noted that it has previously recognized the bankruptcy courts' authority to substantively consolidate debtor entities, as have other circuit courts, though it is an "extraordinary remedy." It continued, however, to point out that only the Ninth Circuit has ever permitted substantive consolidation of debtor and non-debtor entities. Further, it emphasized that no court has ever consolidated a debtor and a non-profit non-debtor entity, "let alone a debtor and over 200 non-profit non-debtors."

The Eighth Circuit then examined § 303(a)'s prohibition of involuntary bankruptcy proceedings involving non-profit entities. The court found that permitting the involuntary proceeding for the non-debtor entities under § 105(a) would be in direct contravention of § 303 of the Bankruptcy Code, precluding such relief. The court affirmed the denial of the Committee's motion for substantive consolidation.

http://my.mnbar.org/blogs/karl-johnson/2018/08/02/eighth-circuit-bankruptcy-court-cannot-substantive

Debtor's False Oral Statement About a Single Asset Does Not Preclude Discharge of Debt

In *Lamar, Archer & Coffrin, LLP v. Appling,* 138 S.Ct. 1752 (2018), the Supreme Court held that a debtor's statement about a single asset can be a "statement respecting the debtor's financial condition" under § 523(a)(2). When the "fraud" at issue is effectuated by such a statement, however, the *Appling* court noted that the statute "plainly heightens the bar to discharge" because the creditor must also satisfy the requirements of § 523(a)(2)(B), which notably requires that such statement be made in writing. In the *Appling* case, the court held that the debtor had made a statement respecting his financial condition, but in the absence of a writing, the court declined to except the debt from discharge.

The debtor in *Appling* was a law firm client. Debtor and the law firm met in person to discuss his outstanding legal fees and whether they would continue to represent him in a civil lawsuit. In that context, debtor told his lawyer that he would soon receive a tax refund for $100,000 and the refund would be sufficient to pay his outstanding legal fees as well as all future legal fees. At the time debtor made the statement, however, he had already received the tax refund for a lesser amount and spent the entire amount on other business expenses. The law firm eventually sued and obtained a judgment against the debtor.

Debtor filed a chapter 7 bankruptcy case and shortly after, the law firm commenced an adversary proceeding, objecting to discharge. After trial, the bankruptcy court excepted the debt from discharge and found that debtor had knowingly made two false representations upon which the law firm reasonably relied, causing the law firm to be damaged in the amount of its unpaid fees. The district court affirmed, but the 11th Circuit reversed. The *Appling* Court affirmed the 11th circuit, holding that the debtor's statement about his tax refund was a "statement respecting his financial condition," notwithstanding the fact that it was only one asset, and therefore, under § 532(a)(2)(B), the statement had to be made in writing for his debt to the law firm to be excepted from discharge.

http://my.mnbar.org/blogs/karl-johnson/2018/07/06/debtors-false-oral-statement-about-a-single-asset

The Eighth Circuit Determines Whether There is an Agreement for Attorneys' Fees under 11 U.S.C. § 506(b) and Whether an Untimely Request for the Same under a Chapter 11 Plan is a Material Breach

In *McCormick v Starion Financial (In re McCormick)*, 894 F.3d 953 (8th Cir. 2018) (Beam, J.), the Eighth Circuit held that "the entirety of the dealings" between the debtors and the creditor provided for attorneys' fees even if the oversecured status arose from nonconsensual judgment liens.

A creditor objected to the debtors' second amended plan of reorganization because the plan did not provide for the creditor's attorneys' fees as an oversecured creditor pursuant to 11 U.S.C. § 506(b). The debtors filed an addendum to the plan, agreeing to pay allowable costs and fees. The plan required the creditor to submit an itemized statement of fees and expenses at least ten days prior to the plan's effective date. The creditor timely submitted a statement for various costs, but after the deadline submitted an updated statement that included its attorneys' fees. The debtors disputed that the creditor was entitled to attorneys' fees because: (i) there was not an agreement for the payment of fees; (ii) the fee request was not timely; and (iii) the fees were not reasonable.

The bankruptcy court denied the creditor's request for fees because the creditor's status as an oversecured creditor arose out of state judgment liens that were not part of any agreement. The creditor appealed to the Bankruptcy Appellate Panel for the Eighth Circuit. The BAP reversed the decision of the bankruptcy court and remanded to determine the fee award. The debtors appealed the fee award to the BAP and the BAP affirmed. The debtors appealed to the United States Court of Appeals for the Eighth Circuit.

The Eighth Circuit considered whether there was an agreement for fees as required under § 506(b) and whether the creditor's request for fees was timely submitted to the bankruptcy court. The debtors maintained there was not an agreement for fees, arguing that the fees were not consensual because the judgment liens arose by operation of law. The Eighth Circuit disagreed, explaining that there were many agreements in which the debtors agreed to pay the creditor's attorneys' fees, including notes, mortgages and a workout agreement. In addition, the court found it significant that the confirmed bankruptcy plan provided for the payment of fees, which took place after the judgment liens were entered.

The Eighth Circuit acknowledged that the fee submission was not timely. However, the court found that it was not a material breach of the plan provisions. The court, relying on North Dakota law, found that the breach was not material because there was no prejudice, the breach was cured almost immediately, and the creditor was not guilty of unfair dealing with the late submission.

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Homestead Sale Proceeds Do Not Lose Exempt Status During Pendency of Bankruptcy Case

In *In re Thomas*, No. 17-43661-MER (Bankr. D. Minn. Jul. 31, 2018), the court, applying the "snapshot rule," held that homestead sale proceeds that are exempt on the petition date maintain their exempt status irrespective of whether the exemption expires post-petition.

The debtor sold her homestead less than a year before filing her chapter 7 petition. In her schedules, the debtor exempted proceeds from the sale of her homestead in the amount of $51,860.00 under Minn. Stat. § 510.07, which provides an owner may sell or convey the homestead without subjecting it, or the proceeds of such sale for the period of one year after sale, to any judgment or debt.

The chapter 7 trustee objected to the exemption of homestead proceeds to the extent such proceeds remained in the debtor's possession one year after the sale of the home. The trustee argued that the plain language of Minn. Stat. § 510.07 must be interpreted to mean the exemption of proceeds lapses or expires one year after the sale. If proceeds remain one year after sale, such proceeds would be bankruptcy estate property.

The court overruled the trustee's objection and denied the motion—applying the "snapshot rule" to limit exemptions to the circumstances existing on the petition date. The court found that the proceeds exited the bankruptcy estate once exempted. In reaching its decision, the court also analyzed 11 U.S.C. § 522(c), which provides "property exempted under this section is not liable during or after the case for any debt of the debtor that arose…before the commencement of the case…"

http://my.mnbar.org/blogs/karl-johnson/2018/08/10/homestead-sale-proceeds-do-not-lose-exempt-status

The Eighth Circuit Holds Again That a Minnesota Property Tax Refund is Not Government Assistance Based on Need and Not Exempt under Minn. Stat. § 550.37, Subd. 14.

In *Hanson v. Seaver (In re Hanson),* 903 F.3d 793 (8th Cir. 2018) (Smith, J.), the Eighth Circuit held that a Minnesota property tax refund does not fit within the Minnesota Legislature's definition of "government assistance based on need" and is therefore not exempt under Minn. Stat. § 550.37 Subd. 14.

The Chapter 7 Trustee objected to the debtor's claimed exemption of a Minnesota property tax refund as "government assistance based on need" under Minn. Stat. § 550.37, Subd. 14. The trustee based his objection on the Eighth Circuit BAP's decision in *Manty v. Johnson*, 509 B.R. 213 (BAP 8th Cir. 2014). The debtor argued that Manty v. Johnson had a progeny issue as the case it derived its legal analysis from was overturned by the Eight Circuit in *In re Hardy*, 787 F.3d 1189 (8th Cir. 2015).

In *Hardy*, the Eigth Circuit decided that the refundable portion of the Additional Child Tax Credit (ACTC) was exempt as a "public assistance benefit" under Missouri law. As it did in the Hardy decision, the Eighth Circuit analyzed: 1) the Minnesota Legislature's intent in passing the property tax refund act; 2) the history of the statutes and amendments thereto; and 3) the operation of the statute in practice.

The Eighth Circuit contrasted the Minnesota statute with the ACTC, finding that its express intent does not include providing relief to needy individuals, and, in practice, households with a significant income are eligible for a partial refund. On the other hand, the ACTC has a $26,300 phase-out for an individual with one child. The panel also noted that since enactment of the Minnesota Property Tax Refund Act the Minnesota Legislature has expanded eligibility for a property tax refund to higher-income earners. Finally, the Eighth Circuit also noted that other provisions of the Minnesota Property Tax Refund Act allow for a refund irrespective of income, but rather based solely on the increase in an applicant's property taxes over the prior year.

The Eighth Circuit concluded its analysis of the Minnesota Property Tax Refund Act by holding that, in summary, "an overwhelming emphasis on benefitting the poor does not exist." The BAP's decision was affirmed.

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