Bankruptcy Bulletin
A Publication of the Minnesota State Bar Association Bankruptcy Section

May 2006

IN THIS ISSUE

Clarification Of The Standards For Collateral Estoppel And Dischargeability

Debtors' Tax Refunds Exempt Because They Were Not Subject To Attachment And Execution

Attorney's Dual Representation Of Debtor And Bank Is Impermissible

Probate Exception Not Applicable When Addressing Claim Objection And Conversion Analysis

Subordination Of Administrative Expense Claim Appropriate Even Where Fraudulent Conduct Unrelated To Claim

Objection To Homestead Exemption Claim Overruled For Failing To Sufficiently Allege Fraud

Bankruptcy Court Applies "First-Filed" Rule In Dismissing Adversary Proceeding

ANNOUNCEMENTS

CLARIFICATION OF THE STANDARDS FOR COLLATERAL ESTOPPEL AND DISCHARGEABILITY

In *Jamrose v. D'Amato* (*In re D'Amato*), No. 05-6055EM (B.A.P. 8th Cir. 2006) the B.A.P. reversed the bankruptcy court's ruling which relied upon collateral estoppel to support a determination that certain of the Debtors' debt was to be excepted from discharge under 11 U.S.C. § 523(a)(6).

Approximately 400 plaintiffs (the "Plaintiffs") sued the Debtors pursuant to 11 U.S.C. § 523(a)(6) for allegedly fraudulent conduct by the Debtors. The Plaintiffs alleged that the Debtors used false reports from the Better Business Bureaus in the Missouri area ("BBB") to induce them into purchasing bogus travel club memberships. Prior to the Debtors' bankruptcy filing, the BBB obtained a partial summary judgment against the Debtors in the Federal District Court for violating copyright laws and counterfeiting under the Lanham Act ("Partial Summary Judgment"). After the Debtors filed for bankruptcy, the Plaintiffs filed their nondischargeability complaint and moved for summary judgment against the Debtors in reliance of the Partial Summary Judgment the BBB had obtained in the Federal District Court. The Bankruptcy Court ruled that collateral estoppel could be applied to the Partial Summary Judgment that the BBB had obtained against the Debtors. The Debtors appealed.

The B.A.P. stated that in order to establish collateral estoppel, a party had to establish that (1) the issue sought to be precluded is identical to the issue previously decided; (2) the prior action resulted in a final adjudication on the merits; (3) the party sought to be estopped was either a party or in privity with a party to the prior action; and (4) the party sought to be estopped was given a full and fair opportunity to be heard on the issue in the prior action. The B.A.P. noted that it was concerned whether or not a partial summary judgment could be considered to be a "final adjudication" under the second prong of the four step analysis. It noted that under Missouri law, a partial summary judgment was not considered final. Moreover, it noted that federal circuits were split on the issue of whether a partial summary judgment was to be treated as a final adjudication. There are courts that have held a partial summary judgment was "per se" not final, while other courts have considered a partial summary judgment to be final if "any judicial decision upon a question of fact or law which is not provisional and subject to future change by the same tribunal." The B.A.P. noted that the 8th Circuit seemed to favor the more liberal approach rather than the per se rule. Ultimately, the B.A.P. stated that it did not need to reach a conclusion as to whether the Partial Summary Judgment should be considered to be "final" in order to resolve the appeal.

The B.A.P. held that the Plaintiffs could not establish, based upon the Partial Summary Judgment, that a willful and malicious injury had occurred as to each of the 400 Plaintiffs. "Willful" means that the injury, not merely the act leading to the injury, must be deliberate or intentional. A "malicious" injury is one that is targeted at the creditor, in the sense that the conduct is certain or almost certain to cause financial harm. The B.A.P. stated that the BBB's Partial Summary

Judgment, which was relied upon by the Plaintiffs, could not show that each of the 400 Plaintiffs were individually targeted in order to make a showing the Debtors' conduct was malicious. Because of the absence of any evidence that the 400 Plaintiffs were individually targeted by the Debtors, the B.A.P. reversed the Bankruptcy Court's grant of summary judgment in favor of the Plaintiffs.

DEBTORS' TAX FOUND EXEMPT BECAUSE THEY WERE NOT SUBJECT TO ATTACHMENT AND EXECUTION

In *Benn v. Cole* (*In re Benn*), No. 04-6053EM (B.A.P. 8th Cir. 2006) and *Mohrhard v. Cole (In re Mohrhard)*, No. 04-6054EM (B.A.P. 8th Cir. 2006) the B.A.P. held that the Debtors anticipated tax refunds were exempt because such tax refunds were not subject to attachment and execution under Missouri or federal law.

The Debtors anticipated receiving tax refunds from both their federal and state tax returns. The Debtors scheduled the state and federal tax refunds as exempt property in their bankruptcy schedules. They relied upon Missouri statute, Section 513.427, which states that:

> Every person by or against whom an order is sought for relief under Title 11, United States Code, shall be permitted to exempt from property of the estate any property that is exempt from attachment and execution under the law of the state of Missouri or under federal law, other than Title 11, United States Code, Section 522(d), and no such person is authorized to claim as exempt the property that is specified under Title 11, United States Code, Section 522(d).

The basic question before the B.A.P. was whether the Debtors' anticipated state and federal tax returns were subject to "attachment and execution" under Missouri law or federal law by any of the Debtors' creditors. The B.A.P. concluded that because tax refunds are not subject to attachment and execution under Missouri law or federal law, tax refunds are exempt pursuant to Missouri statute, Section 513.427.

Chief Judge Kressel dissented. His position was that section 513.427 is not an exemption statute. Indeed, he questioned whether the statute was instead a "wordily drafted opt-out statute." Kressel further noted that the B.A.P.'s holding would lead to unintended consequences. As an example, Kressel stated that if debtors owned property in Kansas, it could be exempt under the majority's holding because that property would not be subject to attachment under Missouri law. Kressel would have affirmed.

ATTORNEY'S DUAL REPRESENTATION OF DEBTOR AND BANK IS IMPERMISSIBLE

In *Briggs v. LaBarge* (*In re James McGregory*), No. 05-6054EM (B.A.P. 8th Cir. 2006) the B.A.P. affirmed the Bankruptcy Court's decision finding an impermissible conflict of interest in the situation where a debtor's attorney who became employed by a bank where he arranged home mortgage refinancing for the debtor.

This was an appeal from a judgment of the United States Bankruptcy Court for the Eastern District of Missouri granting judgment in favor of the trustee's motion for an order denying attorneys fees and requiring disgorgement of fees paid. Ross H. Briggs filed a chapter 13 bankruptcy case on behalf of debtor James McGregory and received a flat fee of $1,700, paying $99 up front and the remaining $1,601 of the attorneys fee were to be paid through the Plan, for his services in the bankruptcy case. While an attorney representing the debtor, Briggs became employed with Wells Fargo Bank, N.A. as a "home mortgage consultant" whereby he arranged home mortgage refinancing for chapter 13 debtors in other parts of the country. During his employment with Wells Fargo Bank, Briggs continued to represent the debtor in this case and in fact, arranged a refinancing transaction for the debtor with Wells Fargo. The bankruptcy court found that Briggs' participation in the refinancing process both as the debtor attorney and as an employee of the lender was an actual conflict of interest that prevented him from being loyal to both his client and his employer. Further, the court found that the debtor's purported waiver of the conflict was invalid because it was a direct conflict that could not be waived under Missouri law. Finally, the court ordered disgorgement of all fees paid, and denial of future attorney's fees. The B.A.P. affirmed on all issues.

PROBATE EXCEPTION NOT APPLICABLE WHEN ADDRESSING CLAIM OBJECTION AND CONVERSION ANALYSIS

In *In re Litzinger*, No. 05-6035EM (B.A.P. 8th Cir. 2006) the B.A.P. partially affirmed and partially reversed the Bankruptcy Court's decision finding that debtor converted at least a portion of the assets of a probate estate. In 2005, this case was before the B.A.P., which remanded for a determination on the applicability of the probate exception from the Bankruptcy Court. The Bankruptcy Court found that the probate exception did not apply and allowed the probate estate's claim. The debtor again appealed. The issues before the court were whether the probate exception applied and whether debtor converted certain assets of the probate estate.

The Second and Ninth Circuits have adopted a two-part test to determine whether a particular lawsuit implicates probate matters. First, is the bankruptcy court being asked to administer an estate or probate a will? Second, does entertaining the cause of action constitute an "impermissible interference" with the probate proceedings? An interference is impermissible if the federal district court (1) interferes with probate proceedings; (2) assumes general jurisdiction over the probate proceedings; or (3) asserts control over property that is in custody of the state court. If either of the above questions is answered in the affirmative, the case must be dismissed for lack of subject matter jurisdiction.

Agreeing with the Bankruptcy Court, the B.A.P. determined that making a determination on the claim objection did not constitute an impermissible interference. The B.A.P. then went on to address the basis of the probate estate's claim, which was conversion. Quoting the restatement of Torts, the B.A.P. set out the definition of conversion, which is "an intentional

exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may be required to pay the other for the full value of the chattel." Restatement (Second) of Torts § 222A. The B.A.P. noted that the actor's intent is of course an important factor in determining whether a conversion occurred. It then noted that the definition of intent requires that the actor desire the consequences of the act. In other words, it must be demonstrated that the defendant intended to do the act depriving the person of his property.

Here, the Bankruptcy Court found that conversion occurred in two instances. The first was when debtor withdrew funds from an account that held money belonging to the probate estate. The second was when a third party garnished funds out of an account that held funds belonging to the probate state. The B.A.P. affirmed the conversion in the first instance. The B.A.P. reversed the second claimed conversion because their was no act by Debtor to deprive the probate estate of property.

SUBORDINATION OF ADMINISTRATIVE EXPENSE CLAIM APPROPRIATE EVEN WHERE FRAUDULENT CONDUCT UNRELATED TO CLAIM

In *In re Racing Services, Inc.*, No. 05-6052ND (B.A.P. 8th Cir. 2006), the B.A.P. affirmed the Bankruptcy Court's order subordinating debtor's administrative expense claim against the bankruptcy estate of Racing Services, Inc. ("RSI") for post-petition rent. Susan Bala ("Claimant") owned a building occupied by RSI. RSI continued to occupy Claimant's building post-petition. Claimant filed an application for allowance of administrative expenses for post-petition rent. The Chapter 7 Trustee and the State of North Dakota objected and argued that the claim should be equitably subordinated. After the objections but before the hearing on Claimant's application, criminal judgments were entered against RSI and Claimant on twelve counts including money laundering and conducting illegal gambling operations. As part of this criminal conviction, the United States of America received a forfeiture judgment against RSI in the amount of $99,013,200.

Courts apply a three-part test to determine whether equitable subordination is appropriate. First, the claimant must have engaged in some sort of inequitable conduct. Second, the claimant's misconduct must result in injury to the creditors of the bankrupt or confer an unfair advantage on the claimant. Finally, equitably subordinating the claim must not be inconsistent with the provisions of the Bankruptcy Code.

Claimant put forth three arguments in support of her claim. First, the criminal behavior was not related to her claim for rent. Second, no creditors were injured by her criminal conduct. Finally, equitable subordination of her rent claim was inconsistent with sections 365(d)(3) and (4) of the Bankruptcy Code. The B.A.P. held that whether her criminal conduct was related to her claim for rent was irrelevant. The B.A.P. found that the injury to creditors was established by the forfeiture judgment. As to the final argument, the B.A.P. determined that neither Section 365 nor Section 510 of the Bankruptcy

Code contain any language prohibiting a bankruptcy court from equitably subordinating a claim in the lease context.

OBJECTION TO HOMESTEAD EXEMPTION CLAIM OVERRULED FOR FAILING TO SUFFICIENTLY ALLEGE FRAUD

In *In re Osland*, 05-2440ADM (D. Minn. 2006), the District Court affirmed the Bankruptcy Court's allowance of Debtor's claimed homestead exemption. Debtor's ex-wife ("Appellant") objected to Debtor's homestead exemption "to the extent he encumbered any exempt or non-exempt portion of the property's value after January 11, 2005." The apparent basis for the objection was the state divorce court's order dated January 11, 2005, which prohibited Debtor from further encumbering any personal assets. Debtor obtained a second mortgage on his home on February 23, 2005, in order to cover payroll obligations of his closely held corporation. The Bankruptcy Court overruled Appellant's objection finding that she did not allege sufficient facts to warrant a finding that Debtor's second mortgage was obtained with intent to defraud creditors.

The District Court affirmed, also finding that sufficient allegations of fraud were absent from Appellant's objection. The District Court recognized that merely converting non-exempt assets to exempt assets is not in and of itself fraudulent. The District Court further noted that the violation of the state divorce court's order did not automatically give rise to a finding of fraud. While the District Court was sympathetic to Appellant's position, it did not find the Bankruptcy Court's factual determination clearly erroneous.

BANKRUPTCY COURT APPLIES "FIRST-FILED" RULE IN DISMISSING ADVERSARY PROCEEDING

In *In re Mansfield Corp.*, 339 B.R. 194 (Bankr. D. Minn. 2006), the Minnesota Bankruptcy Court determined that the first-filed rule, as well as the doctrine of judicial estoppel, supported the dismissal of an adversary proceeding, which was wholly duplicative of a proceeding pending in Utah. *In re Mansfield Corp.* arose out of three bankruptcy cases that were substantively consolidated in the United States Bankruptcy Court for the District of Utah. This adversary proceeding brought before the Bankruptcy Court in Minnesota by the Trustee of the consolidated estates ("Plaintiff") was the second commenced by the Plaintiff against the Defendant. Both cases were based on the same facts and the same substantive theory of recovery. Defendant moved for dismissal.

In cases of concurrent jurisdiction, the first-filed rule stands for the proposition that the first court in which jurisdiction attaches has priority to consider the case. In applying the rule, a court first must determine if there are any compelling circumstances not to apply the first-filed rule. If there are no compelling circumstances to support maintaining identical actions in two forums (whether one would be under stay or not), a trial court may dismiss the later-filed action, at its discretion.

In reaching its conclusion the Bankruptcy Court considered that Plaintiff chose the Utah venue for his

litigation in the first place and he had already parlayed consolidation of all three cases toward a single deemed date of commencement, which was most advantageous to his defense of the Defendant's bid for dismissal on application of the Utah statute of limitations. Concluding Plaintiff already has the benefit of the exercise of the bankruptcy jurisdiction by a federal court, in the District of Utah, and the merits of his case will receive full consideration by an experienced and knowledgeable jurist there. Thus, given the significant judicial attention in the Utah litigation already, this Court should defer to the litigation preceding there. Plaintiff's subjective wish to preserve all possible vectors for a recovery does not constitute a "compelling circumstance," objective in nature, that justifies departing from the first-filed rule. Thus, there is no real cause to stay rather than dismiss the litigation of this adversary proceeding.

Dear Members of the MSBA Bankruptcy Section,

Eighth Circuit Bankruptcy Pro Bono Website

The Pro Bono Committee is pleased to announce the creation of a new Eighth Circuit Bankruptcy Pro Bono website, a valuable online resource for bankruptcy attorneys providing pro bono legal services. The new website, located at www.bankruptcyprobono.org contains a wealth of information for attorneys practicing here in Minnesota and in the Eighth Circuit. Included on the site are BAPCPA materials, summaries of student loan decisions from this district as well as the BAP and 8th Circuit, materials regarding credit card dischargeability proceedings, debtor/creditor counseling materials, links to other bankruptcy law resources, and information regarding our local volunteer attorney programs. We encourage you to take a look at the new website; it is free and does not require a password. We hope that the new website will encourage more attorneys to take on pro bono cases, and will greatly assist those already doing pro bono work.

Nominations for the Raeder Larson Public Service Award

The Committee requests your assistance in gathering nominations for the annual Raeder Larson Public Service Award, which recognizes attorneys who provide outstanding service to the public through the provision of pro bono legal services and dedication to a system of equal justice for all. Judge Kishel will present the Raeder Larson Public Service Award at the Pro Bono reception July 25, 2006. To that end, we need nominations from you. Please email all nominations to Bill Fisher at William.Fisher@gpmlaw.com, along with a short description of the pro bono services provided by your nominee.

Thank you for your attention to these matters. We hope you will find the new website useful, and we look forward to receiving your nominations for the Raeder Larson award.

Sincerely,
The MSBA Bankruptcy Section's Pro Bono Committee

LEGAL CLERK (CLERICAL)
U.S. DEPARTMENT OF JUSTICE
MINNEAPOLIS, MN
$32,947 - $47,591

The Office of the United States Trustee in Minneapolis, MN has a full time excepted service, position available to provide clerical and administrative support. **Six months of bankruptcy experience is required.** Applications, submission procedures and qualification requirements are available at www.usajobs.opm.gov Re MN-06-004. Applicants should submit a resume or OF-612 Optional Federal Employment Application or SF-171 to U.S. Dept. Of Justice, Executive Office for U.S. Trustees, 20 Massachusetts Ave., NW, 8th Fl., Washington, DC 20530, Attn: Janel Bomann EO/Reasonable Accommodation Employer.

Office of U.S. Trustee
300 South Fourth Street, #1015
Minneapolis, MN 55415

Office of U.S. Trustee
230 So Phillips Ave. #502
Sioux Falls, SD 57102

Means Test Seminar

- **Your invited by the United States Trustee Offices of Minnesota and North Dakota to attend a seminar on "The Means Test."**

- **When:** **Tuesday, May 23, 2006**
  from 9:00 a.m. to 12:00 p.m.

- **Where:** **Second Floor Jury Room**
  Quentin N. Burdick U.S. Courthouse
  655 First Avenue North
  Fargo, ND 58102-4932

- **Please RSVP no later than Thursday, May 18, 2006**
  to cherlyn.r.levoir@usdoj.gov

The Bankruptcy Section is sponsoring a summer boat cruise on Wednesday, July 19, 2006. Please mark your calendars accordingly. Invitations will be sent in June to section members.