# Bankruptcy Bulletin

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## IN THIS ISSUE

## CREDITOR OBJECTING TO DEBTOR'S CHAPTER 11 PLAN COULD NOT SUPPORT ITS CLAIM THAT UNSECURED CREDITORS WOULD RECEIVE MORE IN A CHAPTER 7 LIQUIDATION

In the case of In re Feneis, 09-60317, (Bankr. D. Minn. Jan. 20, 2010) (J. O'Brien), Citizen's Bank, a secured creditor of the debtor Michael Feneis, objected to the debtor's proposed Chapter 11 Plan. The court found the plan confirmable.

Debtor scheduled $1.6 million in secured claims and $20 million in unsecured claims. The unsecured creditors voted to accept the plan. Citizens, which had a $50,000 secured claim, objected to the confirmation of the debtor's plan asserting the plan was not proposed in good faith; unsecured creditors would receive more in liquidation; and that the plan was not feasible. The court took each argument in turn.

First, on the issue of bad faith, Citizens argued that the plan was proposed in bad faith because it excluded assets that could otherwise be made available to unsecured creditors. These assets included non-exempt equity in the debtor's homestead, jewelry that had been given to the debtor's spouse worth $150,000, and equity of over $500,000 in a family cabin.

The debtor's homestead was unencumbered and valued at $416,700. Citizen's argued that the debtor can only claim an exemption of $330,000, which left $86,700 in equity that should be available to unsecured creditors. The court found this assertion to be misplaced because it ignored the rights of the debtor's spouse. Based on Kipp v. Sweno, the court found that the entire exemption in this instance would apply to the debtor's interest in the property only, which is half of the value of the homestead, or $208,350. As to the jewelry, the court found that this property was gifted to the debtor's spouse over time and while he was solvent. Thus, the debtor did not have an interest in the property, nor was it subject to avoidance. The $500,000 worth of equity in the family cabin was also not available to creditors under the debtor's plan. The debtor was liable on the mortgage covering the property, however, his adult children were making the mortgage payments, and the debtor had never held title to the property.

Second, the court analyzed Citizen's claim that unsecured creditors would receive more in a chapter 7 liquidation than they will under the plan. This argument was based largely upon Citizen's assertion that the homestead, jewelry and family cabin were part of the debtor's estate. As described above, the court found that these assets would not be included in the debtor's Chapter 7 estate.

Citizen's also claimed that the debtor's retained business interests had value such that unsecured creditors would receive more in liquidation. The plan proposed did not provide for contributions to creditors from these business interests. The court found that this argument failed because the debtor presented credible evidence that the value of those interests were such that the distribution to the unsecured creditors would be greater under the plan. Citizens did not provide any evidence to the contrary.

Lastly, Citizens claimed that the debtor's plan was not feasible. The debtor proposed to fund the plan through a combination of future earnings, liquidation of a business interests, and borrowing. Citizens contended that the plan was not feasible because the entities that employed him lacked the ability to pay him. The debtor provided evidence on the viability of the entities and their ability to pay salaries to that debtor, which Citizens did not rebut.

Citizens also argued that the plan was not feasible because funding depended upon the debtor's spouse consenting to a loan against a life insurance policy in which she had an interest and making an additional $150,000 loan to the debtor, neither of which she was obligated to do. The debtor testified that his wife was willing to do both, however, his wife did not testify herself. There was an agreement between her and the estate attached to the plan which she had not signed, but the debtor had. The court held that if she signed the agreement and if she did create a "Loan Account" for $150,000, she would be sufficiently obligated to these loans which would in turn make the debtor's plan feasible. Based upon this the court conditionally confirmed the plan over Citizen's objections.

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**ATTORNEYS ARE DEBT RELIEF AGENCIES AND THE ADVERTISING AND ADVICE PROVISIONS ARE CONSTITUTION**

In Milavetz, Gallop & Milavetz, et al. v. U.S., 2010 WL 757616 (Supreme Court March 8, 2010), the United States Supreme Court, in a unanimous opinion, upheld certain provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") that relate to debt relief agencies. Specifically, the Supreme Court held that (i) attorneys representing consumer bankruptcy debtors are debt relief agencies as defined by 11 U.S.C. § 101(12A); (ii) consumer bankruptcy attorneys are prohibited from advising a client to incur more debt in contemplation of a bankruptcy filing under 11 U.S.C. § 526(a)(4); and (iii) such attorneys are required to comply with the advertising disclosure requirements of 11 U.S.C. § 528.

The plaintiffs in this case, a Minnesota law firm, the president of the law firm, a bankruptcy attorney at the law firm, and two of the law firm's clients, filed a preenforcement suit in the United States District Court, District of Minnesota ("District Court") seeking declaratory relief, asserting that the law firm was not bound by the debt-relief agency provisions of BAPCPA. Therefore, the law firm (i) could advise their bankruptcy clients to incur additional debt in contemplation of a bankruptcy filing, and (ii) was not obligated to make certain disclosures in the law firm's advertisements. The District Court held that attorneys are not included in the definition of debt relief agencies and 11 U.S.C. §§ 526(a)(4) and 528 are unconstitutional as applied to that class of professionals. The Eighth Circuit affirmed in part and reversed in part. The Eighth Circuit rejected the District Court's holding that attorneys are not debt relief agencies, upheld the disclosure requirements of attorneys in advertising, and held that 11 U.S.C. § 526(a)(4) is unconstitutional because it prohibits debt relief agencies from advising a client to incur any additional debt in contemplation of a bankruptcy filing, even when that advice is sensible. The Supreme Court granted certiorari.

Section 101(12A) of the Code defines a debt relief agency as "any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer…." Bankruptcy assistance is defined by Section 104(A) of the Code as "any goods or services sold or otherwise provided to an assisted person with the express or implied purpose of providing information, advise, counsel, document preparation, or filing, or attendance at a creditors' meeting or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding under this title." An assisted person is defined in Section 101(3) of the Code as "any person whose debts consist primarily of consumer debts and the value of whose nonexempt property is less than $164,250." In their appeal, the plaintiffs argued that attorneys are not debt relief agencies as defined by 11 U.S.C. § 101(12A); therefore, attorneys are not bound by the advice restrictions of 11 U.S.C. § 526(a)(4) and the advertising disclosure requirements of 11 U.S.C. § 528. The Supreme Court disagreed and held that attorneys are debt relief agencies because certain bankruptcy assistance, including legal representation related to a case or proceeding, can only be provided by an attorney.

Because attorneys representing consumers are debt relief agencies, the Supreme Court examined whether such attorneys are prohibited from giving advice to debtors to incur additional debt in contemplation of a bankruptcy filing and required to include specific language in its advertising that the law firm and its attorneys are a debt relief agencies. First, the Supreme Court analyzed Section 526(a)(4), which articulates the restrictions of debt relief agencies, including advising an assisted person or prospective person to incur more debt in contemplation of a bankruptcy filing. The Eighth Circuit found Section 526(a)(4) overly broad and concluded that the section prohibits advising an assisted person to incur any additional debt. The Supreme Court, over concerns that such a broad interpretation would undermine the attorney/client relationship, rejected the Eighth Circuit's interpretation of the statute and concluded that the statute "prohibits a debt relief agency only from advising a debtor to incur more debt because the debtor is filing for bankruptcy, rather than for a valid purpose." Next, the Supreme Court examined Section 528, which requires certain disclosures from debt relief agencies. The Supreme Court concluded that Section 528 is not unconstitutional because the disclosure requirements are reasonably related to the government's interest in preventing consumer deception.

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**CREDITOR'S CLAIM AGAINST ONE DEBTOR WAS NONDISCHARGABLE UNDER 11 U.S.C. § 523(A)(2)(A) FOR ACTUAL FRAUD AS RELIANCE WAS JUSTIFIABLE**

In Treadwell v. Glenstone Lodge, Inc., Case No. 09-6023 (B.A.P. 8th Cir. Feb. 1, 2010) (J. Kressel), the B.A.P. reversed in part and affirmed in part the Western District of Missouri Bankruptcy Court regarding the dischargeability of a debt of Debtors Carole and Larry Treadwell.

Debtor Carole Treadwell, owner of Memory Travel and a member of the Red Hat Society, Inc., was in charge of organizing a social event for the club's members, the "redhatters", at Glenstone Lodge. In the year-long preparation of the event, Carole frequently communicated with a salesperson at Glenstone Lodge via e-mail, and also visited Glenstone Lodge. Carole arranged to have all the event registrations and payment go through her. Before the event, Carole paid only a $250 deposit, and Glenstone Lodge waived the other required payments prior to the event. At the end of the event, the redhatters owed Glenstone Lodge over $60,000.

Carole greatly underestimated the cost of the event but she continued to organize the event at Glenstone Lodge and made "knowingly false" representations about being able to pay Glenstone Lodge for its services. She even used $10,000 of the money she collected from the redhatters to pay for her mother's funeral. Despite promises to pay Glenstone Lodge after the event, Carole only wired $15,000 to Glenstone Lodge after the event. As a result Glenstone Lodge sued the Debtors and was awarded a $153,611.44 default judgment, (including treble damages) which created a lien against their residence.

The bankruptcy court concluded that the debtors' debt was not excepted from discharge because Glenstone Lodge did not prove that it justifiably relied on Carole's misrepresentations. On appeal, the B.A.P. noted that the standard of "justifiable reliance" is a lower standard than "reasonable reliance" and entails no duty to investigate. Field v. Mans, 516 U.S. 59 (1995). A creditor's reliance must be justifiable, but it does not need to need to be reasonable. Unless there are obvious warning signs that a debtor's representation is false, then a creditor may justifiably rely on the representation because the victim should be given the benefit of the doubt and a "victim's contributory negligence is not a defense to an intentional tort." Sanford Institution for Savings v. Gallo, 156 F.3d 71, 74 (1st Cir. 1998). In this case, Carole never made an obvious statement that she would not pay for the event. Despite the recognition that Glenstone Lodge made a poor business decision, based on the frequent communication and the appearance that the event would be a great success, the B.A.P found that Glenstone Lodge's reliance was justifiable under the lower standard. Therefore, the bankruptcy court's decision that Glenstone Lodge's judgment against Carole Treadwell was dischargeable was reversed.

However, the B.A.P. affirmed the bankruptcy court's decision that the judgment against Larry Treadwell was dischargeable. Based on 8th Circuit precedent, the B.A.P. ruled that Glenstone Lodge's judgment against Larry is nondischargeable only if Larry was a partner or agent of Memory Travel, and if he knew or should have known of Carole's fraudulent behavior. Even though Larry is Carole's husband, he had no authority to conduct Memory Travel's business or act on behalf of the business, so he was not a partner or agent of Memory Travel. Also, Larry did not pay the household or business bills and there was no evidence that he knew Carole could not fully pay Glenstone Lodge, so he was unaware of Carole's fraud.

Finally, the B.A.P. held that Glenstone Lodge's lien was avoidable under 11 U.S.C. § 522(F)(1)(A) and the determination as to dischargeability was not a basis for avoiding or not avoiding any lien.

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## CHAPTER 7 TRUSTEE'S RETENTION OF SPECIAL COUNSEL UNDER 11 U.S.C. § 327(E) APPROVED

In In re Polaroid Corporation, et al, 2010 WL 299481 (Bankr. D. Minn. 2010) (J. Kishel), the Bankruptcy Court entered an order approving the Chapter 7 trustee's application for the employment of Lindquist & Vennum, PLLP ("L&V") as special counsel for the estates, under 11 U.S.C. § 327(e) ("L&V Application"). Ritchie Capital Management, LLC, et al. ("Ritchie") and Acorn Capital Group, LLC ("Acorn") objected to the L&V Application, on the basis that L&V would have a conflict of interest in representing the bankruptcy estates in the adversary proceedings against Ritchie and Acorn.

Prior to the debtors' conversion of the cases to Chapter 7, L&V represented the debtors in a number of matters, including a motion for sale of substantially all of the debtors' assets and the commencement of adversary proceedings against Richie and Acorn for the purpose of avoiding the defendants' liens against certain assets of the Debtors and subordinating or recharacterizing their claims. Ritchie and Acorn challenged the Chapter 7 trustee's employment of L&V as special counsel because of L&V's prior and ongoing representation of Douglas A. Kelley, who is receiver for the Thomas J. Petters proceedings in the United States District Court and Chapter 11 trustee in the

Petters bankruptcy cases. Ritchie and Acorn asserted that L&V's representation of Kelley prevents L&V from serving as the Chapter 7 trustee's special counsel in the adversary cases against them because of "current, actual and disabling," "insoluble and inherent" conflicts of interest.

The Bankruptcy Court focused on the distinction between employment under 11 U.S.C. § 327(a), which governs the employment of the estate's general counsel and 11 U.S.C. § 327(e), which governs the employment of the estate's special counsel. Section 327(a) requires that the attorney must "not hold or represent an interest adverse to the estate" and must be a "disinterested person." Whereas, Section 327(e) simply requires that the attorney "not hold or represent an interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed." The Bankruptcy Court also noted that while general counsel is in involved in the analysis of and strategizing regarding all claims of the estate, special litigation counsel is limited to the analysis and strategy with respect to the specific litigation for which it is hired.

The Bankruptcy Court analyzed the following three requirements of Section 327(e), which must be met if a trustee is to continue the engagement of counsel: (i) the attorney must have represented the debtor; (ii) the representation must be in the best interests of the estate, and (iii) the attorney must not hold or represent an interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed. The Bankruptcy Court concluded that all three requirements were met. First, prior to the conversion, L&V represented as debtors-in-possession at least two of the plaintiffs in the adversary cases. Second, L&V's representation is in the best interest of the estates because the facts plead in the adversary complaints support the claims and the pursuit of the claims are justified. Furthermore, L&V's previous involvement in, and knowledge of, the complex matters related to the subject matter of the adversary cases will assist in the prosecution of the cases and benefit the estates. Finally, L&V has not represented Ritchie or Acorn in any matter, and particularly in any matter in connection with the subject matter of the adversary cases for which the Chapter 7 trustee seeks L&V's employment on behalf of the estates. Thus, the Bankruptcy Court approved the employment of L&V to represent the bankruptcy estates in the two adversary cases against Ritchie and Acorn.

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## COLLATERAL ESTOPPEL PREVENTS RELITIGATION OF FACTUAL ISSUES BEARING ON DISCHARGEABILITY

In Tri-State Ins. Co. v. JoAnn M. Stewart, et al., Adv. No. 09-3092, (Bankr. D. Minn. 2010) (J. O'Brien), the Bankruptcy Court applied collateral estoppel to prevent the debtor from relitigating factual issues determined in a prior state court case in connection with a dischargeability determination.

JoAnn M. Stewart ("Stewart"), owned and operated a commissioned-based collection agency, Valley Collections LLC ("Valley"). Over the course of twelve years, Stewart collected outstanding debts owed to Valley's clients, but did not remit the applicable percentage of those funds to Valley's clients. Instead, Stewart diverted the collected funds into Valley's operating account (from its statutory trust account) and used them for her personnel and business expenses.

In 2004, the Minnesota Department of Commerce (the "MDC") discovered

Valley's failure to remit collected funds to its clients and, as a result, revoked Valley's collection license and successfully moved for the appointment of a receiver. An audit performed by the receiver concluded that Stewart had misappropriated a substantial amount of client trust funds. Shortly thereafter the State of Minnesota commenced a criminal action against Stewart alleging various claims based on Valley's failure to remit collected funds to its clients. Stewart plead guilty to and was convicted of several of those counts as part of a plea bargain.

After indemnifying the MDC, Tri-State Insurance Company ("Tri-State"), Valley's surety, commenced a civil action against Stewart to recover the monies paid to the MDC. The state court entered judgment in favor of Tri-State finding that Stewart had misappropriated and converted trust funds for her own use. Shortly after judgment was entered against her, Stewart filed a Chapter 7 petition. Tri-State commenced an adversary proceeding seeking to except its judgment from discharge under 11 U.S.C. §§ 523(a)(2), (a)(4) and (a)(6).

In its motion for summary judgment, Tri-State argued that the state court findings and judgment and Stewart's admissions as part of her plea bargain in the criminal case established that Tri-State's judgment was non-dischargeable. Stewart contended that the elements required to establish a non-dischargeable debt under the applicable sections of the Bankruptcy Code were not determined in either civil of criminal cases and, therefore, she was entitled to present a defense on the merits.

Citing Eight Circuit precedent, the Bankruptcy Court noted that collateral estoppel applies in bankruptcy courts to prevent relitigation of issues (legal or factual) determined in a prior state court action. The Bankruptcy Court further noted that that preclusive effect extends to proceedings concerning dischargeability.

The Bankruptcy Court found that the undisputed facts of the case (as reflected in the state court and criminal proceedings) established that Tri-State's judgment was non-dischargeable. Having had a full and fair opportunity to respond to all relevant factual allegations in the state court and criminal proceedings, the Bankruptcy Court noted, Stewart was bared from relitigating those issues.

**UNPERFECTED MORTGAGE AVOIDABLE UNDER 11 U.S.C. § 547**

In Wells Fargo Home Mortgage, Inc. v. Lindquist, __ F.3d __ (8th Cir. 2010), the Eighth Circuit upheld the bankruptcy and district courts 2006 determinations that an unperfected mortgage is deemed transferred immediately before the filing of a bankruptcy petition pursuant to 11 U.S.C. § 547(e)(2)(C). Accordingly, the court affirmed the holding that the pre-petition transfer of an unrecorded mortgage from debtor Dean Harold Westlund ("Westlund") to Wells Fargo Home Mortgage, Inc. ("Wells Fargo") was avoidable as a preference under 11 U.S.C. § 547(b).

Over two years before Westlund filed his petition for Chapter 7 bankruptcy relief, Wells Fargo made a loan to Westlund. In return, Westlund executed a promissory note payable to Wells Fargo and granted Wells Fargo a mortgage on his home. Wells Fargo neglected to record the mortgage. Nevertheless, Westlund listed Wells Fargo as a secured creditor on his petition. The bankruptcy court granted Westlund a discharge and closed the case.

Upon learning that Wells Fargo had not recorded the mortgage before Westlund filed for bankruptcy, the Chapter 7 trustee sought to reopen the case in order to avoid

Westlund's transfer of the mortgage to Wells Fargo under 11 U.S.C. §§ 547(b) and (e)(2)(C). The bankruptcy court reopened the case and ruled in favor of the trustee on its motion for summary judgment. The district court subsequently affirmed.

The Eighth Circuit noted that there was no dispute that Westlund's grant of the mortgage to Wells Fargo was a "transfer of interest of the debtor in property" or that Westlund was insolvent at the time of his bankruptcy petition. The court then affirmed that 11 U.S.C. § 547(e)(2)(C) operates to deem the transfer of an unperfected mortgage to have occurred immediately before the filing of a bankruptcy petition. Because Wells Fargo had loaned funds to Westlund over two years before the petition date, the court found it clear that the transfer of the mortgage was "for or on account of an antecedent debt owed by the debtor before such transfer was made" and that Wells Fargo was a creditor when it received the transferred mortgage. Thus, the court established that the first five elements required by 11 U.S.C. § 547(b) in order for a transfer to be subject to avoidance as a preference were fulfilled.

The court then turned to the final element and Wells Fargo's argument that it did not receive more than it would have in a hypothetical liquidation because of the transfer. Disagreeing with Wells Fargo, the court noted that Westlund had listed Wells Fargo as a secured creditor, and, as such, Wells Fargo had been allowed to retain the mortgage, which it later sold. If Wells Fargo had not sold the mortgage, the trustee would have been able to liquidate its value and distribute the proceeds to unsecured creditors, who would have received less than the full value of their claims. Consequently, Wells Fargo received the full value of its claim, whereas, in a hypothetical liquidation, as an unsecured creditor, Wells Fargo would have received less. Accordingly, the court concluded that the transfer of the mortgage was avoidable as a preference under 11 U.S.C. § 547(b).

## DISTRICT COURT DENIES HOMESTEAD EXEMPTION BASED UPON REVERSE PIERCE OF CORPORATE VEIL

In *Hecker v. Chrysler Financial Services Americas, LLC*, Case No. 09-50779 (D. Minn. Jan. 6, 2010) (J. Magnuson) the United States District Court for the District of Minnesota affirmed the Bankruptcy Court's denial of the debtor's attempt to reverse pierce the corporate veil to claim a homestead exemption in a property owned by an affiliated company. The property was owned by Jacob Holdings of Cross Lake, LLC, which was a limited liability company owned 100% by Jacob Holdings of Minnesota, LLC. The debtor owned 91% of Jacob Holdings of Minnesota, with the remaining interests owned by his auto dealership and children's trust. The debtor testified that he structured ownership in this manner to keep the property out of his marital estate. The debtor moved into the property shortly before the bankruptcy.

The District Court affirmed the Bankruptcy Court's denial of the exemption. The facts showed that the debtor did not use the Jacob Holdings of Minnesota as an instrumentality and that it was not his alter ego. While the debtor paid the mortgage and the taxes on the property, he booked those as loans to the LLC. The LLCs owned numerous other real estate assets. The debtor "used JPMN as an investment vehicle, to purchase investment properties and to hold those properties in an entity with favorable tax treatment and no personal legal liability."

The Court further found that the exemption would harm the creditors and that since the debtor sought to create the exemption on the eve of bankruptcy, his personal creditors had no opportunity to lien the property. The Court summarized that "Minnesota law does not permit an individual to pick and choose when to hide behind a corporate shield."

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