

Bankruptcy Bulletin

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***“Provider Of Legal Services Plan”
Qualifies As “Petition Preparer” And
“Debt Relief Agency”***

In *McDermott v. Jonak (In re Shadley)*, Bky. No. 10-57095 (Bankr. D. Minn., March 29, 2013), the bankruptcy court held that a business which holds itself out as a provider of “legal services plan” in connection with bankruptcy must comply with requirements imposed upon petition preparers and debt relief agencies, even where the “legal services plan” provider does not type the bankruptcy forms.

Edward Jonak and his company 3rd Millennium Systems, Inc. (the “defendants”) advertised in print, on billboards, and on www.affordablelawcenter.com, as providing “low cost legal aid to those seeking to avoid potentially costly and unnecessary legal fees” in connection with bankruptcy, debt settlement and credit restoration. Customers paid fees between \$363.00 and \$680.00 to become one year members in defendants’ “legal plan.” The one year contract stated that defendants did not provide legal advice, nor would defendants prepare bankruptcy documents. Instead the defendants operated as a “resource center” which would provide “access to resources for all legal, tax, and financial issues.” Defendants had relationships with attorneys, who on only a few occasions provided assistance to defendants or were referrals for customers. It appears that more often the defendants would provide advice and information on bankruptcy issues, including guidance on exemptions, dischargeability and how a customer could keep his or her

home while in bankruptcy. The defendants sold the program on their ability to “provide the most affordable assistance at the highest quality available compared to any similar legal organizations, guaranteed.”

For customers who sought bankruptcy, defendants would provide a questionnaire to facilitate the preparation of the bankruptcy filing documents. Once completed, the form would be sent to an out-of-state typist, who went by the name “Justin Jurist.” Customers then communicated directly with Jurist, who charged an additional fee. Customers disclosed Jurist’s role in the petition preparation, but only three out of eighteen filers disclosed defendants’ role. Several customers professed confusion regarding defendants’ role, some even believing defendants were attorneys.

The court found that defendants qualified as bankruptcy petition preparers under 11 U.S.C. section 110, notwithstanding Jurist’s role in preparing the bankruptcy forms. Section 110 defines a bankruptcy petition preparer as “a person, other than an attorney for the debtor or any employee of such attorney, who prepares for compensation a document for filing.” Courts have given the definition a broad meaning to apply to anyone involved in the filing process, and even the defendants’ purported conduit role as a “resource center” would qualify. Moreover, defendants provided guidance in the process, including exemption elections.

Defendants violated several requirements imposed against petition preparers including: (1) failing to sign

the bankruptcy forms and providing an identifying number; (2) failing to provide customers a written notice as to defendants' status; and (3) failing to file a declaration as to fees received. Defendants also violated section 110(e)(2)'s prohibition on providing legal advice related to several issues in the bankruptcy filings. Moreover, the extensive reference to "legal services" or similar terminology in program advertising and the unauthorized practice of law also constituted "fraudulent, unfair, and deceptive acts" in violation of section 110(i)(1) of the Code.

Defendants also qualified as a debt relief agency under section 101(12A) of the Code, which 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 under section 110." Defendants met the *per se* test since they were petition preparers under section 110 and because the program specifically aimed to facilitate bankruptcy filings.

Defendants violated several obligations imposed on debt relief agencies. Defendants failed to clearly and conspicuously acknowledge its status as a debt relief agency in its advertisements in violation of sections 528(a)(3) and (a)(4). Defendants failed to clearly disclose and also misrepresented the services they would perform in violation of Sections 528(a)(1)(A) and 526(a)(3). Defendants also fostered the filing of bankruptcy forms which were untrue and misleading as defendants'

customers failed to disclose defendants' involvement in the initial bankruptcy filings. Defendants further failed to provide numerous notices to its customers as provided by Section 527.

The court imposed several sanctions for this misconduct. First, under section 110(h)(3), the court awarded complete forfeiture and turnover of all program fees collected by defendants, totaling \$9,389.00. Second, the court awarded the full potential statutory damages of \$2,000.00 per bankruptcy filing under Section 110(i). Third, the court enjoined defendants from any future services other than simply typing information into a bankruptcy form at the direction of a customer. The court noted that a Colorado court had previously enjoined Jonak as a bankruptcy petition preparer.

In conclusion, the court suggested that it would be nearly impossible to serve as a bankruptcy petition preparer and not run afoul of the prohibition against practicing law. As stated by the court:

Debtors will always ask for guidance; even people of advanced education will not know or grasp all the nuances under current law. More to the point, it is inevitable that *they will need it*. When presented with such entreaties, the non-attorney preparer will simply not be able to resist. That is a matter of normal commercial motivation: the customer will expect it, the preparer who doesn't give it won't succeed. And there is the

operation of basic human nature: when someone wants help, how can one turn it down if one thinks it can be given? These observations may not leave even a very narrow place for bankruptcy petition preparers that is viable under section 110, given the utter prohibition of legal advice.

Incarceration Not A Ground To Waiver Of Credit Counseling Requirement

In *Bourgeois v. Bank of America*, No. 12-6056 (8th Cir. BAP, March 22, 2013), the eighth circuit BAP affirmed that a debtor's incarceration is not *per se* adequate grounds to waive the requirement to timely obtain credit counseling.

The debtor filed chapter 7 bankruptcy to save his house from foreclosure (although he filed the petition one day after the foreclosure sale). The debtor was in jail when he filed bankruptcy and moved for an extension to complete the credit counseling requirement for an additional fifteen days after filing. Three days later, the bankruptcy court denied the motion and dismissed the case. The debtor filed a motion for reconsideration more than fourteen days after the dismissal order. The court denied the motion for reconsideration. The debtor filed a notice of appeal, which he signed within fourteen days after denial of the reconsideration motion, but which the court did not receive until after the fourteen day deadline. The BAP initially dismissed the appeal but re-opened the matter when the debtor demonstrated that he delivered the appeal for mailing within the

prison system prior to the fourteen day deadline. Under the prison mailbox rule applicable to *pro se* filers, the BAP permitted his appeal to proceed.

The debtor could only appeal the motion for reconsideration because he had not filed the motion within fourteen days of the dismissal order. Thus, the debtor failed to preserve appeal rights as to the dismissal order. The court treated the motion for reconsideration as a rule 60 motion to seek relief from the prior order on the grounds of mistake, inadvertence, surprise, excusable neglect, newly discovered evidence, or fraud, misrepresentation, or misconduct by an opposing party. An appellate court's review of an order denying a rule 60 motion is "limited" and the standard is an abuse of discretion.

The BAP found the bankruptcy court did not abuse its discretion. The debtor's sole argument was that his incarceration should permit him additional time to obtain credit counseling. The BAP noted several decisions nationwide had rejected the argument that incarceration should warrant a waiver of the credit counseling requirement.

Eviction Order Affirmed On Law Of The Case Where Court Previously Held Debtor Lacked Ownership Interest In Property

In *Alexander v. Jensen-Carter*, No. 12-2476 (8th Cir. 2013), the eighth circuit affirmed an eviction order based on law of the case where numerous courts had previously held the debtor lacked an ownership or exempt interest in the property.

Alexander and Stephens were husband and wife and they resided in a property owned by Alexander prior to the marriage. In 1998, Alexander moved out, filed divorce, and filed bankruptcy. He claimed an ownership in the property, but did not claim it as exempt. Stephens shortly thereafter filed bankruptcy. She claimed she rented the property and did not claim it as exempt.

Jensen-Carter, trustee for Alexander, moved to evict Stephens in state court. The state court denied the relief because Stephens had a marital homestead interest in the property and a possessory interest.

It surfaced thereafter that Alexander had delivered a quit claim deed to Stephens and her son prior to the bankruptcy filings, but such deed went unrecorded until after the bankruptcy. Jensen-Carter filed an avoidance action to avoid the deed, and sought eviction of Stephens as part of the action. Stephens claimed the action untimely. The federal district court denied Jensen-Carter's motion for summary judgment, denied the eviction request in part based on the prior state court order and *Rooker-Feldman*, and referred the matter back to the bankruptcy court.

Jensen-Carter and Hedbeck, trustee for Alexander, settled their dispute between their respective estates as to ownership of the house (recall that no debtor claimed as exempt). The trustees sought authorization to market and sell the property, which the bankruptcy court granted after

Stephens failed to demonstrate any interest in the property. The BAP and eighth circuit affirmed. Subsequently, Jensen-Carter sought to evict Stephens, and the bankruptcy court approved the request, relying in part on its finding from the sale motion that Stephens lacked an ownership or exempt interest.

The BAP and eighth circuit affirmed the eviction order, largely on the ground that the court earlier affirmed that Stephens lacked any interest in the property under the law of the case. Further, the state court and the district court's prior orders denying Jensen-Carter's eviction requests were interlocutory orders which did not finally decide the property interests at stake.

Claim Against Co-Debtor Spouse Allowed Despite Privity Of Contract

In *In re Zych*, the United States Bankruptcy Court for the District of Minnesota entered an order allowing a claim against co-debtor spouses for insurance premiums, where only one of the debtors had executed the insurance policy.

Prior to bankruptcy the debtor (husband) entered into an insurance contract and failed to pay premiums. When the husband and his wife filed a joint petition, the insurance company filed a claim against them jointly for \$49,048. The debtors objected on the grounds that the claim was improper as to the wife since she was not a party to the contract.

The court found that the wife was liable for the premiums because the debtor's wife has a "Substantial Beneficial

Interest” under the Federal Crop Insurance Act (the “Act”) and is therefore responsible for the obligations under the Act. As federal law, the Act preempted state law requiring the wife to be a signatory of the contract to be enforceable against her.

Further, the Court held that the parties had a right to arbitrate, because the automatic stay extended the time to seek arbitration under the insurance contract.

Conversion To Chapter 11 Granted Against A Debtor Not Subject To “Means Testing”

In *In re Schlehuber*, the B.A.P. affirmed the United States Bankruptcy Court for the District of Nebraska’s order converting debtors’ chapter 7 bankruptcy case to a case under chapter 11, pursuant to section 706(b) of Title 11 of the United States Code (“the Bankruptcy Code”).

In January 2012, co-debtor spouses filed a voluntary petition for relief under chapter 7 of the Bankruptcy Code. Their debts were primarily business debts and their schedules showed a substantial monthly surplus and significant income.

An unsecured creditor filed a motion seeking to convert the chapter 7 to a chapter 11 under Bankruptcy Code section 706(b), alleging debtors had significant income to fund a chapter 11 plan. After the motion to convert was filed the debtors amended their schedules to show that they had no monthly disposable income. The bankruptcy court determined, based on debtors’ earnings statements and tax

documents, that the debtors would have significant monthly disposable income. The bankruptcy court ordered the conversation.

Citing *Willis v. Rice (In re Willis)*, the B.A.P. stated that the decision whether to convert is a matter of discretion of the bankruptcy court based on the interests of all parties and what would further the goals of the Bankruptcy Code. *Willis*, 345 B.R. 647 at 654 (B.A.P. 8th Cir. 2006).

The B.A.P. held that the bankruptcy court acted within its discretion under section 706(b). First, it found that conversion was not an effort to end run section 707(b)’s requirement that an individual debtor have primarily consumer debts. It further stated that because confirmation of a plan is a goal in Chapter 11, the ability to pay is a logical consideration under section 706(b).

The B.A.P. was unwilling to second guess the bankruptcy court’s record-based determination that the debtors had the ability to fund a chapter 11 plan and stated that it is not necessary that a chapter 11 debtor be engaged in business to reorganize. Upholding conversion, the B.A.P. reasoned that a bankruptcy court must consider the interests of all of the parties and the individual debtor’s interests are not the sole consideration.

Creditor Who Relinquished Its Possessory Lien Without Adequate Protection Agreement Loses Rights In Collateral

In *In re WEB2B Payment Solutions, Inc.*, the eighth circuit B.A.P. upheld the

United States Bankruptcy Court for the District of Minnesota's order granting summary judgment in favor of the Chapter 7 trustee and affirmed the bankruptcy court's ruling that a creditor relinquished its possessory lien in account funds when it turned the funds over to the trustee without requesting adequate protection.

Prior to bankruptcy the debtor and creditor had entered into an agreement under which the debtor submitted electronic deposits of funds captured from checks received by the debtor. Upon the rejection of any of these checks, the creditor was entitled to recover the funds from the debtor's accounts held by the creditor.

As of the debtor's petition date, the creditor held nearly a million dollars of the debtor's funds. The creditor continued to exercise its setoff rights upon the accounts until the trustee requested the turnover of the funds held in the account. The creditor turned over the majority of the funds (holding back some funds to satisfy its continuing setoff rights), without requesting adequate protection for the liens that it held in the funds.

After exhausting its holdback, the creditor requested a portion of the funds turned over to the trustee be returned to it to satisfy continuing setoff rights and claimed a security interest in the funds. The creditor subsequently filed an adversary proceeding, seeking a determination that it held a first priority security interest in the funds it had turned over to the trustee. The bankruptcy court held that the creditor's priority possessory lien was lost upon the

turnover of the funds to the trustee, without first seeking adequate protection.

The eighth circuit B.A.P. affirmed the bankruptcy court's ruling, reasoning that while sections 542 and 362 required the turnover of the funds, the creditor was required to seek adequate protection in order to maintain its interest. Based on the reasoning in *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995), the court explained that had the creditor wished to preserve its setoff rights, it should have had a temporary freeze placed on the account while seeking a court determination regarding the relative rights of the parties via a motion for relief from stay or for adequate protection. By voluntarily relinquishing the funds, without any court determination as to rights, it voluntarily surrendered its possessory interest in the funds and lost its right to setoff.

Debt Based On A Debtor's Willful And Malicious Conversion Through Entities He Controlled Deemed Nondischargeable Under 11 U.S.C. section 523(A)(6)

In the chapter 7 case of *Phillips, et al. v. Phillips (In re Phillips)*, Adv. No. 11-3400 (Bankr. D. Minn. Feb. 22, 2013), the court held that the plaintiffs' debt was nondischargeable under 11 U.S.C. section 523(a)(6) due to the debtor's intentional conversion of property through entities which he wholly owned or controlled.

The plaintiff sued the debtor (her step-son) in both her individual capacity and as personal

representative of the estate of her late husband, the debtor's father. The other plaintiff to the action was an entity for which she was the sole member, officer and governor.

Prior the debtor's bankruptcy filing, he was the chief executive, majority owner and individual in control of two corporations. He and those corporations were sued by the plaintiffs in state court for conversion of property. The bankruptcy filing stayed the proceedings against the debtor, but not against the corporate defendants, and that action proceeded to trial in the state court.

The state court found that the debtor removed and disposed of the property at issue and that his corporations wrongfully converted plaintiffs' property. The state court awarded judgment in favor of plaintiffs in the total amount of approximately \$256,000. At issue before the bankruptcy court was whether the debtor was personally liable for those conversions. The court observed that the only reason judgment was not entered against the debtor personally was because of the stay. The debtor testified in the state court trial, and also before the bankruptcy court, giving testimony that was substantially the same. The court found the debtor's testimony to be "entirely without creditability."

Ultimately, the court found that the evidence demonstrated that the debtor personally controlled the decisions to take the property, dispose of the property and disburse proceeds to himself and his corporations knowing that the property was converted and

that neither he nor his corporations had any legal right to the property or proceeds. Accordingly, the court found that the debtor's actions were "blatant personal acts of willful and malicious conversion of property which he knew belonged to the plaintiffs." The resulting liability was found to be nondischargeable under 11 U.S.C. section 523(a)(6).

This case is currently on appeal to the Bankruptcy Appellate Panel for the Eighth Circuit Court of Appeals. *Phillips, et al. v. Phillips (In re Phillips)*, No. 13-6019 (B.A.P. 8th Cir. filed Apr. 26, 2013).

Repayment Of Short-Term Bridge Loans Fails The Vertical And Horizontal Tests For Ordinary Course Of Business Under 11 U.S.C. section 364(A) And Are Avoidable As Unauthorized Post-Petition Transfers Pursuant To 11 U.S.C. section 549

In *Pillar Capital Holdings, LLC v. Williams (In re Living Hope Southwest Medical Servs., LLC)*, the creditor gave the debtor a number of what were described as "short-term bridge loans" on which the creditor received payment by using blank checks that were pre-signed by the debtor. The trustee sought to avoid those payments as unauthorized post-petition transfers pursuant to 11U.S.C. section 549. In addition, the trustee sought to pierce the corporate veil and hold the creditor's sole member personally liable for the transfers. The bankruptcy court entered judgment against the creditor in the amount of the short-term bridge loan repayments, stating those loans were not in the ordinary course of business, and did not pierce

the corporate veil to hold the creditor's sole member personally liable on that judgment. The district court affirmed the bankruptcy court's decision and an appeal to the eighth circuit by both the creditor and the trustee followed.

The debtor initially filed for bankruptcy under chapter 11 and just short of two years later, the case was converted to one under chapter 7. The creditor's business specialized in assisting companies facing financial difficulty. Prior to the bankruptcy, the sole member of the creditor took an active role in the debtor's business with the intention of perhaps becoming a 50 percent member of the debtor under certain conditions which were never finalized. That individual managed the debtor's personnel matters, financial operations, and advised the debtor on financial, insurance and payroll matters.

While the debtor was struggling with its operations under chapter 11, the creditor made no-interest loans to the debtor in order to keep the business afloat. The loans were made to enable the debtor's payroll checks to clear. A number of checks were "stamp-signed" by the debtor's owner and comptroller but otherwise left blank. The creditor would then obtain one of the blank checks from the debtor's assistant comptroller and write itself a check in repayment of the bridge loan. Through this arrangement, the debtor repaid a total of approximately \$111,000, leaving \$88,500 outstanding. The trustee pursued the recovery of those payments in addition to piercing the corporate veil to hold the creditor's sole member personally liable.

On appeal to the eighth circuit, the creditor challenged the bankruptcy court's decision that the repayments were avoidable post-petition transfers under 11 U.S.C. section 549 and its interpretation of "ordinary course of business" under 11 U.S.C. section 364(a). The trustee cross-appealed the decision not to pierce the corporate veil.

Section 364(a) allows the debtor to obtain credit in the "ordinary course of business" without first obtaining bankruptcy court approval. Because "ordinary course of business" is not defined in the Bankruptcy Code, courts consider the "vertical" and "horizontal" tests in determining whether post-petition transfers are within the ordinary course of business. The "vertical" test looks to whether creditors dealing with the debtor would expect the transaction at issue and whether that transaction is consistent with the debtor's pre-petition dealings. The "horizontal" test considers whether the debtor's conduct is typical in the debtor's industry. The creditor argued that the court should reject the use of both tests in favor of applying the plain language of the statute, and because the loans were used to meet the debtor's operating expenses, they were incurred in the ordinary course of business.

The eighth circuit examined the transactions under both tests. The creditor conceded that it failed the horizontal test (there was no evidence that the transactions were typical in the debtor's industry), and it additionally failed the vertical test

because there was no evidence that the debtor's other creditors had a similar loan-repayment practice. Because the creditor failed both the vertical and horizontal test, the transfers were not in the ordinary course of business and therefore were not sheltered by 11 U.S.C. section 364(a).

Additionally, the Eighth Circuit agreed with the bankruptcy court that the evidence did not support a piercing of the corporate veil. Under New York law, the trustee was required to show that the creditor exercised complete domination or control over the transaction at issue, and that such influence was used to commit a fraud or wrong against the debtor. Here, insufficient evidence existed to show that the creditor committed fraud or conversion, that the creditor's sole member had comingled personal funds, that corporate formalities were not observed, and that the creditor acted contrary to the debtor's possession of funds. In fact, the debtor was aware of the blank-check repayment arrangement, and had the ability to stop payments at any time. Therefore, there was no conversion required to pierce the corporate veil.

Bankruptcy Court Grants Motion For Abstention And Remand, Returning Post-363 Sale Litigation Involving The Enforceability Of Covenants Not To Compete Against Former Employees To State Court

In *Manty, et al. v. Helal, et al. (In re Fifty Below Sales & Marketing, Inc.)*, Adv. No. 13-5004 (Bankr. D. Minn. Apr. 12, 2013), the debtor continued to

operate its sales and marketing service-based business until a chapter 11 trustee was appointed. The chapter 11 trustee operated the debtor's business until it was sold at a section 363 sale. Following an auction, there were two successful bidders for separate blocks of the debtor's assets. Plaintiffs in this action consisted of the chapter 11 trustee and the successful bidder for one block of the debtor's assets, who took over the going-concern business purchased from the bankruptcy estate upon closing. The individual defendants were former employees of the debtor who resigned just weeks before the sale closed and went to work for one of the debtor's direct competitor, another named defendant.

Post-sale, the plaintiffs sued the defendants in state court for wrongfully luring away the debtor's customers by taking a job with the debtor's competitor in violation of their covenants not to compete, and by using proprietary and confidential information. Plaintiffs sought injunctive relief to enforce those covenants not to compete. All but one defendant filed a notice of removal to the bankruptcy court. The removing defendants sought to have the bankruptcy court address what they believed to be a threshold issue arising under bankruptcy law: the identification of the party with standing to enforce the debtor's rights under the defendants' employment agreements post-sale.

The trustee had previously filed a motion for approval of the assumption and assignment of the employment agreements. The defendants objected to

that motion on the grounds that the agreements were no longer executory once the defendants had left the employ of the debtor. Ultimately, that motion was withdrawn by the trustee after the lawsuit was commenced in the state court, and there was no court-approved assumption and assignment of those agreements. Therefore, the removing defendants would have the plaintiffs barred from enforcing those covenants against the individual defendants, and in addition, believed the sale to have specifically excluded assets related to the debtors' past engagement of employees. The removing defendants, therefore, would characterize the threshold issues as sounding under 11 U.S.C. sections 365 and 363, with the bankruptcy court being best situated to interpret and enforce bankruptcy law and its own sale order.

The court explained that the removal of any action from state to federal court carries with it the possibility of abstention and remand. The bankruptcy court may remand such a claim or action "on any equitable ground" pursuant to 28 U.S.C. section 1452(b). In addition, 28 U.S.C. section 1334(c) allows the bankruptcy court to abstain from hearing a particular proceeding arising under, or arising in or related to a case under the Bankruptcy Code "in the interest of justice, or in the interest of comity with State courts or respect for State law."

The removing defendants sought a ruling that the right to enforce the employment agreements (if any still remained) remained with the bankruptcy estate. However, the court

explained that their ultimate success would necessarily require findings that first, the bankruptcy estate could not transfer the employment agreements without first formally assuming and assigning the agreements pursuant to section 365, second, the benefits and burdens of the agreements could not be severed as a matter of nonbankruptcy law and third, that binding employees (past or present) to their employment agreements could only be done where an ongoing relationship existed at the time of the sale.

So, while sections 365 and 363 were initially implicated, the remaining propositions necessary to defeating plaintiffs' claims would be governed exclusively by state law. Additionally, the plaintiffs conceded that the employment agreements were no longer executory – a concession that was late-coming, but significant. Once plaintiffs made that concession, the court noted that the central issue of bankruptcy law asserted by the removing defendants – section 365 – was no longer at play. Addressing the defendants' argument that the § 363 sale formed the basis for the removal, the court noted that first, this was not a core proceeding and second, but for the sale free and clear, the sale was otherwise documented and conducted as it would have been outside of bankruptcy.

Toward that end, the bankruptcy court pointed out that the remaining issues of state law were anything but clear. While the "time-tested" Minnesota law provided that a covenant not to compete in an employment agreement could be

assigned to a purchaser in order to protect the goodwill of the business, the court noted that the parties “haggle tenaciously on the proper application” of that case law to the current facts. The court further observed that the state court’s ultimate decision on this matter would “clearly require some fine-tuning of that governing precedent.”

Accordingly, because Minnesota state law governs the threshold issue of standing, and then the issue of enforceability, the court found that the state court is best positioned to address its own law. Giving further support to that determination is the court’s observation that the enforcement of covenants not to compete in employment agreements has long been recognized in Minnesota as a sensitive subject to be given careful treatment, given conflicting policy considerations. Accordingly, the court held that abstention was warranted and remanded to the state court.

Allergies Do Not Constitute An “Undue Hardship” Sufficient To Make A Debtor’s Student Loan Debt Dischargeable In Bankruptcy

In *Erik J. Nielsen v. ACS, Inc.*, 12-2925 (8th Cir. Apr. 25, 2013) (J. Loken, J. Melloy, and J. Benton), a debtor appealed a judgment denying his request to discharge student loan debt under the “undue hardship” provision of 11 U.S.C. section 523(a)(8). The debtor asserted to the bankruptcy court that severe allergies prevented him from working and thus created an undue hardship sufficient to justify the

discharge of his student loan debt. The bankruptcy court ruled against the debtor finding, among other things, that: (1) the debtor’s allergies did not materially restrict his ability to work; (2) the debtor’s eligibility for the Income Contingent Repayment Program for student loan debt could potentially mitigate the debtor’s hardship; and (3) the debtor had thus failed to establish that his student loan debt was dischargeable based on undue hardship.

The debtor appealed and the Bankruptcy Appellate Panel affirmed the bankruptcy court’s decision. The debtor then appealed to the Eighth Circuit Court of Appeals. The eighth circuit noted that debtors bear a rigorous burden in proving undue hardship under section 523(a)(8) by a preponderance of the evidence. The eighth circuit then concluded that the bankruptcy court did not clearly err in reaching its factual findings and affirmed the bankruptcy court’s decision.

Debtors Cannot Discharge Judgments Arising Out Of A Willful And Malicious Misappropriation Of Trade Secrets

In *Dale Harold Bjerckness, II. v. SKF USA, Inc.*, 12-2744 (D. Minn. Mar. 12, 2013) (J. Frank) and *SKF USA, Inc. v. Joseph John Sever*, 12-2588 (D. Minn. Jan. 18, 2013) (J. Magnuson), Judges Frank and Magnuson of the U.S. District Court for the District of Minnesota analyzed whether an award to a creditor of more than \$1 million in attorneys’ fees constituted non-dischargeable debt under 11 U.S.C. section 523(a)(6).

The debtor-appellants in these cases left their employer, the appellee, several years before filing their bankruptcy cases to form their own, competing business. Before they left the appellee's employ, however, they took thousands of files containing sensitive customer information. When the appellee learned of their actions, it sued the Debtor-Appellants and won a large, joint and several judgment based, in part, on a factual finding that the debtor-appellants had willfully and maliciously misappropriated the appellee's trade secrets. The appellee's judgment was comprised of \$40,000 in compensatory damages, \$40,000 in punitive damages, and more than \$1.1 million in attorneys' fees and related costs. The Debtor-Appellants then filed for bankruptcy.

The appellee filed adversary proceedings against the debtor-appellants asserting that its judgment was non-dischargeable under 11 U.S.C. section 523(a)(6), which excepts from discharge any debts arising out of "willful and malicious injury by the debtor." The appellee prevailed in its adversary proceedings and the debtor-appellants appealed. On appeal, the debtor-appellants argued, among other things, that the injury at issue was not "malicious" as that term is defined under the Bankruptcy Code because it was not substantially certain that, by taking the trade secrets, the debtor-appellants would cause the appellee financial harm. The district court was not persuaded by the arguments of the debtor-appellants and, in both cases, it affirmed the bankruptcy court's denial of discharge.

Appellee-Financial Institutions And Counsel Awarded Costs Where Appellant-Mortgagors Claims Were Dismissed Under 12(B)(6)

In *Purnie Ray Peterson, et al., v. CitiMortgage, Inc. et al.*, No. 12-2530, the eighth circuit affirmed the decision of the U.S. District Court for the District of Minnesota dismissing twenty-one claims brought by approximately thirty-five mortgagors. In the underlying action, plaintiffs attempted to avoid foreclosure by challenging the defendants' rights with respect to mortgages on their homes. More specifically, the plaintiffs' allegations against the defendant-financial institutions included slander of title, breach of fiduciary duty, due process violations, fraud, negligent misrepresentation, conversion, civil conspiracy, unjust enrichment, and equitable estoppel. Such cases are sometimes referred to as "show me the note" cases. The eighth circuit noted that case law was well-established in favor of the appellees in this circuit, and the underlying actions were "the latest in a string of substantially similar cases brought recently in Minnesota." The court went on to describe the claims as frivolous and poorly plead. Not only were the dismissals affirmed, in this case, the eighth circuit required the appellant-homeowners to pay costs and damages to the appellee-financial institutions.

Federal Court Remands Case To State Court Pursuant To 28 U.S.C. section 1334(C)(2)'S Mandatory Abstention Requirement

The case of *Minnesota Life Insurance Company v. Credit Suisse First Boston Mortgage Securities Corporation*, No. 12-02671, was commenced in the Ramsey County District Court, with the plaintiffs alleging that defendants fraudulently sold them over \$43 million in residential mortgage-backed securities. The defendants removed the case to federal district court pursuant to 28 U.S.C. section 1452, asserting that the case was related to the bankruptcy case of GMAC Mortgage, LLC, which had originated some of the loans underlying the securities.

The court granted the plaintiff's motion to remand the case to state court pursuant to the mandatory abstention requirement of 28 U.S.C. section 1334(c)(2). The court stated that the statute requires a federal district court to abstain if: (1) a timely motion was made; (2) the proceeding is based on a state law claim or cause of action; (3) the basis for removal is 'related to' jurisdiction; the only basis for original jurisdiction in federal court is the bankruptcy filing; the proceeding has already commenced in state court; and (6) the action can be timely adjudicated in state court.

The defendants conceded that the first four requirements were met. With respect to the fifth element, the defendants argued that it was satisfied only if there was a pending, parallel state court action, and that if the element was not satisfied by a removed action, because a removed action leaves no duplicative litigation to avoid. The court rejected that argument, holding that mandatory abstention under section 1334(c)(2) is applicable to cases removed under section 1452 because

the text of section 1334(c)(2) requires only that an action was "commenced" in state court, not that an action is also "pending" in state court. With respect to the sixth element, the defendants argued that the case was too large and complex to be timely adjudicated in state court. The court also rejected that argument, pointing to statistics the plaintiff had provided regarding Ramsey County's efficiency and experience with complex litigation. As a result, the court found that the requirements of mandatory abstention were satisfied, and remanded the case to the Ramsey County District Court.

Eighth Circuit Affirms Dismissal When Claim For Quiet Title Based On Rejected Show-Me-The-Note Theory And Other Theories Unsupported By Facts

In *Iverson v. Wells Fargo Bank, N.A.*, Case No. 12-2142, the eighth circuit affirmed the district court's grant of defendants' motion to dismiss under rule 12(b)(6) for failure to state a claim. The plaintiffs in the case were thirteen homeowners challenging the impending foreclosure of their home mortgages. When the case was in front of the eighth circuit, the plaintiffs' only remaining claim was to quiet title under Minnesota Statutes, section 559.01. The main theories for the claim were tied to the "show-me-the-note" theory: that the holder of legal title to a mortgage cannot foreclose if he is unable to produce the underlying promissory note. The eighth circuit rejected that theory based on Minnesota Supreme Court precedent. It then rejected the plaintiffs' remaining theories for the claim because the assertions were wholly

unsupported by facts, therefore, were deficient under federal pleading standards.

Real Property Lost Homestead Status And Could Not Be Claimed As Exempt When Owner / Debtor Moved Out With No Fixed Or Actual Intent To Return

In *Paul v. Allred (In re Paul)*, Case No. 12-6068, the BAP held that the bankruptcy court had not erred in concluding that the debtor had abandoned real property as his homestead, and therefore denying his claim to a homestead exemption in such property. The debtor owned the real property in question, but had not lived in the property for around fifteen years, and lived instead in a house owned by his wife. The court, applying South Dakota law, held that real property can be homestead property even if not occupied by the debtor, and that the pivotal issue was whether the debtor had an honest intent to reoccupy the property as a home.

The court found that the debtor had no intent to return to the real property, either at the time he moved out of that property or at the time he filed his petition. The debtor argued that nothing prohibited him from moving back into the property. The court rejected that argument, stating that because the debtor removed himself from the real property with no fixed or actual intent to return, the property lost its homestead status.

Tribal law governs whether debtors have any legal or equitable interest in future monthly per capita payments from revenue at Indian casinos.

In *In re Barth*, 485 B. R. 919 (Bankr. D. Minn. 2013) the debtors, whom are members of the Lower Sioux Indian Community in Minnesota filed for chapter 7 bankruptcy. The trustee, through adversary proceedings, sought orders that required the debtors to turnover post-petition per capita payments that they received from the Lower Sioux Indian Community as net gaming income. The trustee claimed that these payments were contingent property rights that existed at filing constituting 11 U.S.C. section 541 (a) property of the bankruptcy estate.

The bankruptcy court held that Tribal law and not Minnesota law determines the definition of these payments. The court found that just as Minnesota has the authority to define property rights with respect to property within its jurisdiction and which is subject to state law, so does the Lower Sioux nation. Accordingly, the Lower Sioux Indian Community in Minnesota Gaming Revenue Allocation Ordinance section 302(G) governs stating that “[t]he per capita payments are periodic payments, not a property right. The right to receive a per capita payment does not accrue or vest until the Community actually makes a payment to Community Members who qualify.” The court found this provision clear and held that these post-petition payments were not estate property of the chapter 7 debtors.

A bankruptcy court’s interpretation of its own order is overturned only due to abuse of discretion.

In *In re Kelley*, 488 B.R. 97 (8th Cir. B.A.P. 2013), the debtors appealed an order by the bankruptcy court for the

Eastern District of Arkansas requiring them to convey certain real property to the bank. The bank was a long-time creditor of the debtors and held security interests in various parcels of real property owned by the debtors. The debtors filed a chapter 11 plan which the bank objected to and the bank also filed a motion to dismiss the bankruptcy case. As part of an agreed order the bank withdrew its motion and the debtors included language that would require the debtors to “abandon” six parcels of real property to the bank if they did not sell them within one year. The debtors did not sell the six parcels in one year and the bank sought an order, pursuant to the agreement, requiring the debtors convey the properties to the bank. debtors argued that “abandon” did not mean convey as the bank suggested but that it held the meaning of a term of art under the bankruptcy Code meaning abandon from the bankruptcy estate and revert to its prepetition status as property of the debtors.

The BAP upheld the lower court’s decision. The standard of review is that a bankruptcy court’s interpretation of its own order is reviewed for an abuse of discretion. Additionally, a bankruptcy court’s interpretation of the confirmed plan is entitled to deference as an interpretation of its own order and will be an abuse of discretion only if it was based on clearly erroneous factual findings or on erroneous legal conclusions. A finding is clearly erroneous even if there is evidence to support it if the “reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.” According to the BAP, the lower court’s

decision because it was not based on clearly erroneous factual findings or legal conclusions. The lower court was in the best position to interpret the meaning of its own order. The parties’ settlement was that the bank would refrain from exercising its rights at that time in exchange for the right to get the properties back after a year if they were not sold. Although, “abandon” was not the best word, that is what the court understood it to mean in the agreed order.

Student Loans are discharged on a case by case analysis of three factors.

In *In re Mathieu*, BKY 12-31428 (Bankr. D. Minn. 2013) the debtor brought an adversary proceeding seeking discharge of her student loan for undue hardship under 11 U.S.C. section 523(a)(8). At trial, the bankruptcy court made the following findings of fact: The debtor graduated in 1992 with a B.A. and a \$20,800 loan with Defendant Educational Credit Management Corporation (ECMC). Shortly after she and her husband at the time bought a dance studio and debtor ran that. The debtor earned an average of \$17,900 per year during this time and then she and her husband divorced. The debtor had a son whom was diagnosed with leukemia as a toddler and has ADHD and Asberger Syndrome. The debtor’s son cannot, and will not for the near future at least, be able to be economically and socially independent. The debtor takes care of her son full time and receives monthly child support that will end in July 2013. Currently, the debtor makes about \$50,400 per year, and this is most likely her peak earning capacity; she also has a second job as a waitress that brings in about \$3,000

per year. The debtor has a low credit score and cannot get access to any reasonable credit because of the loan. ECMC has proposed two payment options that would continue to increase the balance of the loan and would require debtor to make payments until she was 72.

The court ordered that debtor's student loan be discharged under 11 U.S.C. section 523(a)(8) for undue hardship. "Undue hardship cases must be examined in the light of the unique facts and circumstances of each case" considering three factors: "1) the debtor's past, present, and reasonably reliable future financial resources; 2) calculation of the debtors and debtor's dependents reasonable and necessary living expenses; and 3) any other relevant facts and circumstances surrounding each particular bankruptcy case." Using these factors the court found that debtor would likely fail either of ECMC's programs, that she would be left with an undue struggle until the age of 72, and that her expenses would likely increase over the years as she continues to care for her disabled son. Debtor has no savings, little in the way of possessions, and is probably at her peak earning capacity.

Debtor's Evidence Of Property's Value Insufficient To Strip Off Second Mortgage

In the Chapter 13 case of *In re Slovak*, No. 12-47074 (Bankr. D. Minn. Mar. 19, 2013), the bankruptcy court refused to strip off a second mortgage encumbering the debtor's real property because the debtor failed to prove that the second mortgage was wholly

unsecured.

The property was encumbered by two mortgages. The debtor argued that the second mortgage was unsecured because the value of the property was \$95,413 and the amount owed on the first mortgage was \$116,914. In support of the asserted property value, the debtor offered an affidavit with her personal opinion, the results of two home valuation websites, and the tax assessed value. The court found that none of these provided credible evidence. The bankruptcy court found the debtor's affidavit to be unconvincing because it did not provide sufficient information about the property itself – it only provided information about the neighborhood. The bankruptcy court also found that prices from home valuation websites Trulia and Yahoo! Homes were "at best questionable and at worst evidence of nothing." Finally, the bankruptcy court would not accept the county tax assessed value because there was no information about how the assessed value was calculated and the valuation had no other supporting evidence. Without credible evidence of value, the bankruptcy court refused to strip off the second mortgage.

State's Prepetition Judgment Valid As To Post-petition Liability

The case of *Smith v. State of Missouri (In re Smith)*, No. 12-6060 (B.A.P. 8th Cir. Feb. 15, 2013) involved a judgment obtained by the State of Missouri against the debtor for the State's past and future costs of incarcerating him. The judgment provided a mechanism for the State to prove up the future

costs and directed the Department of Corrections to pay it 90 percent of certain deposits made to the debtor's "inmate account". The State obtained the judgment in 2009, the debtor filed a chapter 7 petition in 2010, and the court issued a discharge order in 2011.

In 2012, the Department of Corrections transferred funds from the debtor's inmate account to the State pursuant to the judgment. The debtor responded by filing a motion for contempt against the State for violating the discharge injunction.

The bankruptcy court ruled that the State's judgment was void with respect to all costs accrued as of the petition date, but was valid for costs accrued after the petition date. The debtor appealed, arguing that the judgment was discharged, that the Missouri statute authorizing the judgment for future costs violates the Supremacy Clause, and that the specific funds in his inmate account were protected from collection because they could be traced to his mother's Social Security benefits.

The B.A.P disagreed with the debtor and affirmed the bankruptcy court, holding that 11 U.S.C. section 524(a)(1) voided the judgment only to the extent it represented prepetition debt; the prepetition judgment remains valid for liability relating to the State's postpetition costs. As a result, there was no conflict between state and federal law, and no violation of the Supremacy Clause. Finally, social security benefits are not protected once

the recipient disposes of them.

Eighth Circuit Rules Injury to Creditor Not Willful and Malicious and Confirms that Debt is Dischargeable.

In *Van Daele Bros., Inc. v. Thoms (In re: Jeffrey Thoms)*, No. 12-1161 (8th Cir. February 4, 2013), the debtor was a loan officer for the bank and in that capacity served as the creditor's lending officer. In February 2008, the debtor approached the creditor's owner, who considered the debtor a friend and someone he could trust, with a business proposition. The debtor proposed to sell the creditor cattle for \$75,000, which the debtor would lease from creditor for five annual lease payments of almost \$19,000 each. The creditor would finance the cattle with a loan from the bank. The debtor would maintain possession of the cattle at a lot owned by the creditor's neighbor and care for them.

The debtor prepared all of the documentation. Nothing in the documents explained who would own the future offspring of the original cattle. The creditor's owner testified at trial that the debtor promised to notify him of any changes to the herd. After receiving the purchase price, the debtor paid off a \$68,000 loan to a separate bank that had been secured by the same cattle.

In August 2008, the debtor lost his job at the bank. Nevertheless, the debtor assured the creditor that he would make the first annual lease payment. However, the debtor defaulted when the payment became due in March 2009.

The creditor's owner testified that in

April 2009 he entered the property where the cattle were located and repossessed some cattle. The debtor's father testified that some of the repossessed cows belonged to him and he instituted two replevin actions in state court.

After the creditor repossessed the cattle, the debtor attempted to tender the first lease payment with a check written by his daughter. The debtor said his daughter received a loan from a friend. The friend testified that he made the loan to pay for the daughter's college expenses. The creditor refused the installment payment and demanded full payment in exchange for the repossessed cattle.

The creditor sold the repossessed cattle in late 2009 for approximately \$20,000. The creditor's owner testified that he spent about \$10,000 feeding and caring for the herd prior to the sale.

The debtor filed for a chapter 7 bankruptcy on December 26, 2009. The creditor commenced an adversary proceeding, claiming the debtor's debt should be excepted from discharge because the debtor perpetrated a "willful and malicious injury" upon the creditor. The bankruptcy court found for the debtor, concluding the creditor failed to prove the debtor "committed deliberate or intentional acts which were substantially certain to cause" the creditor harm or that targeted the creditor. The creditor appealed and the BAP affirmed. The creditor appealed again.

On appeal to the eighth circuit, the creditor argued that the bankruptcy court failed to consider objective

information that, according to the creditor's owner, sustained its burden of proof. The eighth circuit rejected that argument and affirmed, reasoning that most of the relevant evidence before the bankruptcy court depended on credibility determinations, and that the appellate court would defer to the bankruptcy court's conclusions in that regard.

Eighth Circuit Confirms Post-Petition Transfers Avoidable But Lender's Owner Not Personally Liable.

In *Pillar Capital Holdings, LLC v. Williams (In re: Living Hope Southwest Medical Services, LLC)*, No. 12-2044 (8th Cir. April 26, 2012), the debtor filed for chapter 11 bankruptcy in 2006 and converted to a chapter 7 liquidation in 2008.

Prior to its initial filing, the debtor obtained a revolving line of credit from a creditor. The debtor was required to deposit all of its collections in a lockbox that was swept daily by the creditor. When it became clear the debtor was struggling, the creditor contacted the lender's owner about whether the lender, an organization specializing in assisting financially troubled businesses, would consider obtaining an interest in the debtor company.

In a letter from the creditor regarding a modification of the debtor's financing arrangement, the creditor provided the lender's owner with an option to become a fifty percent member of the debtor if he provided the debtor with a \$250,000 line of credit subordinated to the creditor and made a \$25,000 good faith payment to the creditor. The

arrangement was not finalized before the expiration date set forth in the letter.

The lender's owner made the good faith payment anyway and began to take an active part in the debtor's business affairs. He suggested the debtor open debtor-in-possession accounts in a New York bank rather than a local bank so that payroll checks would take longer to clear. He also found less expensive insurance and payroll companies. The debtor even announced to its employees that the lender's owner had agreed to come on board as a "financial partner."

Prior to the debtor's chapter 7 conversion, and when it was struggling to make payroll, the lender made several no-interest loans to the debtor. The payments were characterized by the lender's owner, who contemporaneously promised to continue his due diligence to determine whether he would invest in the debtor, as short-term bridge loans.

When the debtor's New York bank accounts were opened, the first ten checks were stamp-signed by the debtor's owner and comptroller but were otherwise blank. The lender's owner attempted to reimburse the lender for the self-described loans by taking a blank check to the debtor's assistant comptroller every time he wrote a check to the debtor and writing in the same amount he loaned to the debtor.

Of the ten checks, six were negotiated and one was dishonored. The six honored checks were addressed to the lender, and the dishonored check was

addressed to the lender's owner.

Following the debtor's conversion, the trustee filed an adversary proceeding seeking to avoid the transfers. The bankruptcy court concluded they were not in the ordinary course of business and therefore avoidable. However, the bankruptcy court refused to hold the lender's owner personally liable, reasoning there was no evidence to support piercing the lender's corporate veil.

The lender challenged whether the transfers were avoidable and the trustee appealed the decision not to hold the lender's owner personal liable.

With regard to whether the transfers were in the ordinary course of business, the eighth circuit held the lender failed the vertical test established by the courts because no evidence suggested that any of the debtor's other creditors participated in any practice akin to that of the lender's blank-check repayment scheme.

The lender failed the horizontal test because the debtor's other creditors would not have reasonably expected the debtor to enter into an arrangement, which enabled the lender to place its claims ahead of other creditors' claims, without the other creditors' knowledge.

The eighth circuit also held that insufficient evidence existed to pierce the corporate veil, relying on evidence that the lender's owner never co-mingled funds and the lender observed the corporate formalities.

Bankruptcy Court Awards Nothing to

Hecker Bankruptcy Trustee.

In *Seaver v. New Buffalo Auto Sales, LLC (In re: Dennis E. Hecker)*, Adv. No. 10-5027 (Bankr.D. Minn., Jan. 24, 2013), the debtor owned a home referred to as Northridge, which was registered as Torrens property, when he filed his Chapter 7 petition in June 2009.

Northridge was encumbered by a first mortgage in favor of U.S. Bank in the original principal amount of \$250,000. It was also encumbered by second and third mortgages in favor of GMAC totaling \$900,000 in their original principal amounts. In addition, Northridge had county and federal tax liens of more than \$2.6 million against it. In total, Northridge was under water by at least \$2,000,000.

In April 2009, Koch Group, LLC obtained a judgment against the debtor, which was later sold to Palladium. In May 2009, New Buffalo and Wagener, who was the Chief Manager of New Buffalo, obtained a judgment exceeding \$324,000 against the debtor. None of the judgment creditors registered their judgments against Northridge's certificate of title, thereby perfecting their judgment liens, prior to the debtor's bankruptcy filing.

U.S. Bank obtained relief from the automatic stay to foreclose its mortgage in September 2009. The foreclosure sale was set for January 19, 2010. Although the debtor was not personally served with the sale notice, he had actual knowledge of it. Notice was mailed to GMAC's nominee on January 8, 2010.

On January 7, 2010, the trustee filed a motion for approval of a settlement with the debtor, his girlfriend, and Thomas - a business associate of the debtor's. The agreement called for a \$75,000 payment from Thomas in exchange for the estate's interest in Northridge.

U.S. Bank credit bid on Northridge at the foreclosure sale and obtained by property for \$213,263. The sheriff's certificate of sale was registered on the certificate of title the same day.

The trustee held the debtor's right to redeem, scheduled to expire on July 19, 2013, but he did not monitor the foreclosure after the stay was lifted. The bankruptcy court approved the settlement with Thomas on January 27, 2010, and the trustee delivered a trustee's deed to Thomas' attorney. Neither Thomas nor his attorney registered the trustee's deed.

In February 2010, GMAC obtained relief from the automatic stay. However, it did not pay off U.S. Bank and it did not foreclose its own mortgages.

In March 2010, Thomas informed the trustee that he just learned of the settlement transaction. The trustee then uncovered that the source of the \$75,000 was four irrevocable trust accounts associated with the debtor. However, the trustee took no action until November 2010 when he obtained a quit-claim deed conveying Thomas' interest in Northridge back to the trustee.

In April 2010, the judgment creditors registered their judgments. They did not first obtain relief from the

automatic stay.

GMAC, the tax-lien holders, and the trustee all failed or chose not to redeem from U.S. Bank. New Buffalo redeemed and thereafter sold Northridge to Palladium for more than \$618,000. Palladium paid \$80,000 in cash and gave a mortgage on Northridge for \$320,000.

In the few days before the judgment creditors redeemed, Palladium's attorney spoke with the trustee several times and the trustee told him that he would not do anything to stop the judgment creditors' redemption and would not assert that the automatic stay precluded redemption.

However, on July 23, 2010, the trustee filed a notice of the bankruptcy on Northridge's certificate of title, and, three days later, he filed an adversary proceeding to avoid the judgment creditors' prepetition judgments as preferences. He later amended his complaint to avoid the postpetition registration of the prepetition judgments.

In March 2011, GMAC published notice of a planned foreclosure sale. The judgment creditors obtained an injunction in state court, arguing that GMAC's mortgage had been wiped out by the U.S. Bank foreclosure proceedings. GMAC filed a petition, naming the judgment creditors as defendants and alleging U.S. Bank's foreclosure was invalid and that the judgment creditors maintained no interest in Northridge. At that point, GMAC was interpleaded in the adversary proceeding.

On cross-motions for summary judgment, the bankruptcy court held that the transfers were not preferences and that registration of the judgment creditors' judgments was not avoidable. On appeal, the BAP affirmed the bankruptcy court on the preference claim but reversed as to whether the judgment creditors' judgment registrations were avoidable.

The BAP then remanded, directing the bankruptcy court to consider whether the trustee's inactions could be raised by the judgment creditors as equitable defenses and whether avoidance of the post-petition judgment registrations would restore the estate to its prior financial condition, or whether a money judgment was necessary.

As to these issues, the bankruptcy court held that there were no recognized equitable defenses to the trustee's avoidance claim so it could not consider them. However, even if the bankruptcy court had such authority, the court held that neither party attempted to induce the other to act in a manner contrary to its interests or operate in a devious or covert manner.

Additionally, the bankruptcy court held that a monetary award would not restore the estate to its pre-transfer condition. On the contrary, it would result in a windfall to the estate because the estate's right of redemption held no monetary value and the registration of the judgments resulted in no loss of value to the estate.

Discretionary Bonuses Paid Post-

petition Not Property Of The Estate

In *Seaver v. Klein-Swanson (In re Klein-Swanson)*, No. 12-6054 (B.A.P. 8th Cir. Feb. 21, 2013), the Bankruptcy Appellate Panel (“B.A.P.”) analyzed two bonuses received by the debtor postpetition and determined that they were not property of the estate.

The debtor filed a petition under chapter 7 on January 19, 2009. In February and March 2009, the debtor received two discretionary bonuses from her employer. Although the bonuses related to her performance during the last quarter of 2008, which was prepetition, the bonuses were within the complete discretion of her employer and there was no evidence that her employer had decided to award the bonuses as of the petition date. The debtor did not disclose her eligibility for the bonuses in her schedules and she was not forthcoming with the trustee about the bonuses after she received them.

The bankruptcy court held that the bonuses were property of the estate. As a result, the trustee could recover the value of the bonuses from the debtor pursuant to sections 549 and 550. Further, the bankruptcy court revoked the debtor’s discharge pursuant to section 727(d)(2), which requires revocation if the debtor acquired property that is property of the estate, or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report the acquisition of or entitlement to such property, or to deliver or surrender such property to the trustee.

11 U.S.C. section 727(d)(2). The bankruptcy court also awarded the trustee costs as the prevailing party.

On appeal, the B.A.P. reversed on all counts. It applied state law to determine that the debtor had no enforceable interest – legal or equitable – to receive the bonuses when the petition was filed. Even though the bonus programs were in place on the petition date and the bonuses were based on the debtor’s prepetition conduct, the decision whether to award the bonuses was in the employer’s sole discretion. The B.A.P. distinguishes cases where the debtor had an existing interest on the petition date, such as a loss-carryback tax refund claim, a purchase option contingent on postpetition events, and a profit sharing agreement. In those cases, the debtor had an enforceable interest on the petition date; in the present case, the debtor did not.

Without a finding that the bonuses were property of the estate, the trustee’s claims for recovery of the value of the bonuses, revocation of the discharge, and award of costs could not stand and the bankruptcy court’s decision was reversed.