2020 Mississippi Bankruptcy Conference
Bankruptcy Law Update

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Selected Cases Decided by the Supreme Court and the Fifth Circuit

Supreme Court Cases

Automatic Stay and Passive "Control."

***City of Chicago v. Fulton*, 19-357 (U.S.), oral argument October 13, 2020.**

The United States Supreme Court heard oral arguments in a case to resolve a circuit split on the question of whether are the automatic stay requires a creditor to turn over repossessed property as soon as the debtor files a chapter 13 case. Section 362(a)(3) of the Code prohibits "any act . . . to exercise control over property of the estate."

The Second, Ninth and Eleventh Circuits require a creditor to turn over repossessed property immediately after the filing. The Third, Tenth and the District of Columbia circuits hold the retention of property maintains the status quo and is therefore not a violation of the stay. These cases arose in the city of Chicago where debtors owed between $4,000 and $20,000 in parking fines. Outside of bankruptcy, the city will not release the impounded vehicles until the debtor pays the fines.

While Justices Alito and Thomas signaled, perhaps, some sympathy for the City's arguments, most of the other justices seemed to have trouble understanding how the continued possession of the vehicles was not an exercise of control, or was not an act to collect a prepetition debt.

This case was argued for the debtor by former Chicago bankruptcy judge Eugene Wedoff, and was the topic of the Duberstein Moot Court competition last year.

Constitutionality of Puerto Rico Financial Oversight Board.

***Financial Oversight & Management Board for Puerto Rico v. Aurelius Investment LLC*, 140 S.Ct. 1649 (2020).**

In a unanimous opinion, the Supreme Court has held that the Financial Oversight and Management Board of Puerto Rico established pursuant to the PROMESA statute did not violate the Appointments Clause of the United States Constitution because the members of the board exercise primarily "local duties."

In 2016, the Supreme Court held that Puerto Rico was not eligible to file under chapter 9 of the Code. Congress responded swiftly with PROMESA, the Puerto Rico Oversight, Management and Economic Stability Act, 48 U.S.C. §§ 2161 *et seq.*, to facilitate the reorganization of Puerto Rico's financial affairs.

The Oversight Board members are not nominated by the President, nor confirmed by the Senate. Rather, they were appointed by the President in a collaboration with the Congress that under the terms of PROMESA meant no Senate confirmation was necessary.

The Appointments Clause of the U.S. Constitution, art. II, § 2, cl. 2, provides that the President "shall nominate and by and with the Advice and Consent of the Senate shall appoint Ambassadors other public Ministers and Consuls and all other Officers of the United States."

Justice Breyer's majority opinion held that although Oversight Board members are "officers of the United States" for purposes of the Appointments Clause, their powers and duties are primarily local, in which case they are not subject to the constraints of the Appointments Clause. In so holding, Justice Breyer rejected the argument that the financial reorganization of Puerto Rico has "nationwide effects." The "the same might be said of any major municipal or even corporate bankruptcy."

The concurrences of Justices Thomas and Sotomayor are noteworthy. Justice Thomas disagreed with Justice Breyer's reasoning that the Board members are "officers of the United States" for purposes of the Appointments Clause. He expressed concern that the "primarily local test" would permit loading up Federal officials with local duties to evade the Appointments Clause. Justice Sotomayor "reluctantly" joined the majority judgement despite her concern that the Board members occupy a "twilight zone of accountability," and therefore represent a challenge to Puerto Rican self-governance.

<u>No *Nunc Pro Tunc* Orders.</u>

***Roman Catholic Archdiocese of San Juan v. Acevedo,* 140 S.Ct. 696 (2020).**

Cases pending in Puerto Rican territorial courts were removed to federal court because they were related to a debtor's bankruptcy case. On March 13, 2018, the bankruptcy court dismissed the bankruptcy case. Later that month, the territorial court in which the case had been filed originally entered various orders in the case. It was not until August 2018 that the case was remanded formally to the territorial court. The order remanding the case to the territorial court stated that the remand order was *nunc pro tunc* – i.e., the order was being entered in August 2018, but the remand was as of March 13, the date the bankruptcy (which was the basis for removal) was dismissed.

In a *per curiam* opinion, the Supreme Court held that the territorial-court orders entered in late March were void because the court at that moment did not have jurisdiction over the case. Jurisdiction did not revest in the territorial court until the case was remanded, which did not occur until August. As for the "*nunc pro tunc*" order, such orders are valid only if entered to remedy an oversight through inadvertence – that is, a failure to enter an order that should have been, and was intended to have been, entered in the past. Such orders are not appropriate where, as in this case, the *nunc pro tunc* order sought to "make the record what it is not."

<u>Denial of Lift Stay Motions Immediately Appealable.</u>

***Ritzen Group Inc. v. Jackson Masonry, LLC,* 140 S.Ct. 582 (2020).**

The Supreme Court unanimously held that the denial of a lift stay motion was a final order and thus immediately appealable. Applying the case of *Bullard v. Blue Hills Bank,* 575 U.S. 496 (2020), Justice Ginsberg's opinion began by acknowledging that bankruptcy cases are an "aggregation of individual controversies," that cannot await the resolution of the entire bankruptcy case to be appealed. The Court in *Bullard* held that bankruptcy court orders are final when they "definitively dispose of discrete disputes within the overarching bankruptcy case." The test for that is whether the order (i) alters the status quo, and (ii) fixes the rights and obligations of the parties.

The opinion cited treatises and commentators to the bolster its holding that a denial of a lift stay motion indeed meets the test of finality. Lift stay motions are anterior to and distinct from the claims resolution process, and thus such motions are in themselves discrete litigation. Moreover, resolution of a stay motion can have large practical effects, such as delay in collecting a debt or a decline in value of collateral. Finally, denial of lift stay motions always should be treated as final orders, although Justice Ginsburg in a footnote stated that the Court was NOT deciding whether such an order that was entered "without prejudice" would be a final order if the judge was entering the order with an eye to "further developments [that] might change the stay calculus."

Selected Fifth Circuit Cases

Local Rule Requiring Turnover of Excess Tax Refund Struck Down.

***Diaz v. Viegelahn (In re Diaz)*, 972 F.3d 713 (5th Cir. 2020).**

The Fifth Circuit struck down a local rule requiring a below median income chapter 13 debtor to turnover income tax refunds in excess of $2,000 to the chapter 13 trustee for distribution to creditors.

The Court held that the local rule was invalid because it conflicts with § 1325(b) as explained in *Hamilton v. Lanning,* 560 U.S. 505 (2010). Judge Clement's opinion began by noting that local rules can only cover procedural, not substantive rights. So, the question in the case boils down to whether the requirement to turn over the tax refund amount in excess of $ 2,000 was an abridgement of substantive rights.

Section 1325(b)(1)(B) requires that "all of the debtor's projected disposable income" go to paying off creditors. Disposable income is calculated by subtracting from current monthly income amounts "reasonably necessary" for the debtor's maintenance and support. In *Hamilton,* the Supreme Court noted that, for below median income debtors such as the one in this case, the amounts "reasonably necessary for maintenance" of the debtor are not part of disposable income. This is in contrast to above median income debtors who only get to deduct amounts specified by the code.

Thus, Judge Clement concluded that § 1325(b)(2) "plainly allows below-median income debtors to retain any income that is reasonably necessary for their maintenance and support." The substantive right to use "excess" tax refunds to pay for the debtor's maintenance and support may not be abridged for efficiency reasons in a local rule in all cases. Because it was "entirely plausible" that the debtor would use the excess tax refund for maintenance and support, the Fifth Circuit vacated the bankruptcy court's order confirming the chapter 13 plan and remanded the case.

The case does not appear to adopt a rule that below-median income debtors can ALWAYS retain their tax refunds, but rather strikes down a blanket rule which would require the debtor to rebut, rather than the trustee pursuing the refund when it comes to light.

No Authority to Order the SBA to Loan Money Under the CARES Act.

***Hidalgo County Emergency Service Foundation v. Carranza (In re Hidalgo County Emergency Service Foundation),* 962 F.3d 838 (5th Cir. 2020).**

The debtor brought an adversary proceeding asking that the SBA be required to make the debtor a "PPP" loan under the CARES Act without regard to the debtor's status in bankruptcy. The bankruptcy judge entered an injunction requiring, under § 525's antidiscrimination provision, that the SBA consider the debtor's loan application without regard to the fact that the debtor had filed a bankruptcy case.

Acting on an expedited schedule, the Fifth Circuit reversed. The Court noted that federal law and Fifth Circuit precedent were clear – there can be no injunctions against the SBA. Thus, the lower court's order was invalid. The Court stated that "the issue at hand is not the validity or wisdom of the PPP regulations and related statutes, but the ability of the court to enjoin the [SBA], whether in regard to the PPP or any other circumstance."

A Full Payment Chapter 13 Plan Should Be Confirmed Without A Nonstatutory Requirement Limiting a Debtor's Right to Modify the Confirmed Plan.

***Brown v. Viegelahn (In re Brown),* 960 F.3d 711 (5th Cir. 2020).**

The Bankruptcy Court confirmed a "full payment" plan on the condition that the debtor would not receive a discharge if unsecured creditors were not paid in full. The trustee had objected to the plan, despite creditors being paid in full, because the debtor had excess disposable income under the plan of $1,000 per month. In essence, the condition imposed by the court in confirming the plan prevented the debtor from modifying the plan unless unsecured creditors were paid in full.

Judge Southwick's opinion reversed the Bankruptcy Court and vacated the confirmation order. Section 1325(a) provides that a court "shall" confirm a plan if the statutory requirements of chapter 13 are met. One of those requirements is § 1325(b)(1) which provides that a court shall not confirm a plan unless (a) the creditors are paid in full or (b) the debtor devotes all of their disposable income to the payment of unsecured claims. The language in the confirmation order was designed to protect the creditors against default by the debtor under the plan while also keeping some of his disposable income.

Because § 1325(b)(1) employs the disjunctive "or," a court shall confirm a plan if either of the two conditions of that subsection are met. The plan in this case is a "full payment plan," and thus satisfies one of the alternatives. Section 105 also was not available as the exercise of power under that section cannot be a means to rewrite the code, which the language in the confirmation order sought to do. The remedy in such situations is not to ignore the plain language of the statute, but rather to argue that a plan modification is in "bad faith" and therefore should be denied.

Bankruptcy Court Findings of Fact on Nondischargeability Case Held "Clearly Erroneous."

***Veritex Community Bank v. Osborne (In re Osborne),* 951 F.3d 691 (5th Cir. 2020).**

A cardiologist and his wife personally guaranteed a business loan and submitted financial information in support of their application. Shortly thereafter, the couple took out another loan with a different lender, but did not update the information they had submitted to support the first loan.

Later, the parties renegotiated the first loan, with the lender extending its maturity. In connection with this negotiation, the spouse submitted financial statements that failed to disclose the second loan and several debt collection actions that the second lender had taken with regard to the second loan.

In the couple's bankruptcy case, the first lender brought a nondischargeability action under § 523(a)(2)(B) – the submission of a false written statement regarding the debtor's financial condition upon which the creditor reasonably relied in extending credit. The bankruptcy court found that the creditor had not "reasonably" relied on the financial statement with regard to the loan extension, and that the failure to update the initial financial information did not constitute a "false financial statement" for purposes of the code.

The Fifth Circuit agreed with the bankruptcy court on the second issue, but reversed the court's findings regarding the loan extension as "clearly erroneous," and thus the debt was nondischargeable. The Court began by noting that the clearly erroneous standard means that bankruptcy court's findings will normally be accepted. Indeed, the Fifth did just that with regard to the initial loan origination. However, the financial statement the spouse submitted in connection with the loan extension clearly omitted salient facts about the couple's financial condition, and thus the court's holding that the lender had not "reasonably relied" on the statement was clearly erroneous.

The bankruptcy court had reasoned that there were sufficient red flags in the financial statement, even without the omitted facts, that the lender should not have extended the loan maturity. The Fifth Circuit stated that the "reasonable reliance" standard is a "low hurdle" meant to deter lenders from getting borrowers to agree to false financial information in order to preserve the argument that the loan is nondischargeable. Where, as here, the borrowers withheld significant financial information, it cannot be said that its reliance was unreasonable. The problem, the Fifth Circuit opined, is that the bankruptcy court paid too much attention to the soundness of the loan rather than the debtors' concealment of relevant financial information.

Finally, the submission of false financial information by a spouse may be imputed to the other spouse under the facts of this case because the spouse was acting as the agent of the debtor in doing so.

Fifth Circuit Affirms Bankruptcy Court's Effort to Prevent Windfall to Debtor from Undisclosed Personal Injury Suit in Chapter 13.

Wal-Mart Stores Inc. v. Parker (In re Parker), **89 Fed.Appx. 462 (5th Cir. 2020) (non-precedential).**

Wal-Mart reopened the debtor's chapter 13 case and brought an adversary proceeding seeking determination that debtor was judicially estopped from pursuing personal injury claim against Wal-Mart because he had failed to disclose the claim in his bankruptcy filings. The United States Bankruptcy Court for the Western District of Louisiana determined that the elements of judicial estoppel were met but ultimately declined to apply the doctrine for equitable reasons, and ordered debtor to turn over any recovery to the trustee to be administered for the benefit of creditors.

The Fifth Circuit affirmed the bankruptcy court, holding that the court did not abuse its discretion in declining to apply judicial estoppel, but requiring debtor to turn over any recovery to the trustee. This result prevents the debtor from receiving a windfall, though it seems to stretch the language of the code which would not permit payments to creditors beyond five years, which is how long the personal injury suit had been pending.

Return of a Fraudulent Transfer Erases Liability of Transferee.

Whitlock v. Lowe (In re DeBerry), **945 F.3d 943 (5th Cir. 2019).**

Before bankruptcy, the debtor's wife took $ 275,000 from their joint bank account and opened a new account with her sister-in-law. The wife then took herself off the second account. The sister-in-law transferred $ 33,500 to debtor's daughter, which the daughter subsequently returned. Then, the sister-in-law transferred $ 200,000 to a company controlled by the debtor, and $ 32,000 to the debtor's wife's personal account.

The trustee successfully sued the sister-in-law for $ 241,500 under the theory that she was the initial transferee of a fraudulent transfer. On appeal, the sister-in-law conceded that the transfer was avoidable. However, she contended that she was a "mere conduit" of the funds, and thus was not liable for the demanded amount.

The Fifth Circuit reversed the Bankruptcy Court, but not on the "mere conduit" theory. Rather, the court held that the trustee may not recover property that the transferee had returned to the debtor before bankruptcy. Some courts reason that such a recovery would give the trustee a "windfall," others apply the "single satisfaction" rule of § 550(a); under either theory, the trustee was not entitled to recovery, at least on the record as it exists. Moreover, it makes no difference that the couple might have "frittered away" the property after it was returned.

The Fifth Circuit vacated the judgment and remanded for further proceedings. In a footnote the court directed the Bankruptcy Court to determine if the $ 232,000 in fact was "returned" to the debtor.

Termination of the Automatic Stay for Serial Filing under §362(c)(3)(A).

***Rose v. Select Portfolio Servicing Inc.*, 945 F.3d 226 (5th Cir. 2019).**

The debtor had filed multiple bankruptcy petitions to stop foreclosures on her home. Section 362(c)(3)(A) provides that, for an individual debtor in chapters 7, 11 or 13 has been dismissed within a year, the automatic stay terminates 30 days after the most recent filing "with respect to any action taken with respect to a debt or property securing such debt . . . with respect to the debtor."

In December 2018, the First Circuit held that this provision leads to the termination of the stay entirely, including regarding property of the estate, as opposed to property of the debtor only. The Fifth Circuit in a *per curiam* opinion refused to adopt this reasoning, which is a minority position in lower courts. The court was not swayed by policy arguments that its position was contrary to the intent of BAPCPA which added this position to the code. Where the statutory language is clear, the court's inquiry ends.