1. Siegel v. Fitzgerald, 142 S. Ct. 1770 (2022) MM

The Bankruptcy Clause of the U.S. Constitution empowers Congress to make "uniform" laws on the subject of bankruptcy throughout the United States. The issue in Siegel v. Fitzgerald was whether U.S. Trustee fee increases adopted in 2017 were constitutional in light of the fact that fee increases were applied differently as between districts that participate in the U.S. Trustee program and districts in North Carolina and Alabama, which are part of the Bankruptcy Administrator program.

In late 2017, Congress amended section 1930(a)(6) to significantly increase the quarterly fees to be paid by chapter 11 debtors during fiscal years 2018 through 2022. From and after January 1, 2018, the U.S. Trustee began charging quarterly fees for chapter 11 debtors using the new formula for both newly-filed and then pending cases, but these fees did not apply in the 6 districts operating under the Bankruptcy Administrator program. So, in September of 2018, the Judicial Conference adopted an amended schedule of user fees for districts participating in the Bankruptcy Administrator program that made comparable fee increases applicable in chapter 11 cases filed in those districts. But even after the Judicial Conference increased fees in Bankruptcy Administrator districts, there were still two significant differences in how these fees applied to debtors. First, the fee increase did not take effect until October 1 of 2018, even though fees in the rest of the country increased as of the first quarter of 2018. Second, the fee increases in Bankruptcy Administrator districts only applied to cases filed after the effective date, whereas fee increases in U.S. Trustee districts applied to pending cases as well as newly-filed ones.

The US Trustee argued that laws concerning the fees to be paid by debtors were not governed by the uniformity requirement of the Constitution because they were about the administration of the bankruptcy system and not substantive bankruptcy law. The Supreme Court rejected this distinction and noted that all courts that have been asked to consider the constitutionality of the 2017 fee increase have agreed that the Bankruptcy Clause's uniformity requirement applies. The Supreme Court also distinguished this statute from others that result in a lack of uniformity by delegating to individual districts the discretion to establish their own procedures for certain bankruptcy matters, including fees, based on local needs and conditions.

The Court also rejected the argument that the need for additional funding in US Trustee districts (but not in Bankruptcy Administrator districts where program costs are paid from the Judiciary's budget) could be used to justify nonuniform fees, noting that the financial need in US Trustee districts only existed in the first place because Congress had arbitrarily separated the country into two different systems with different funding mechanisms. According to the Supreme Court, "The Clause does not allow Congress to accomplish in two steps what it forbids in one."

The Supreme Court noted that, although the Bankruptcy Clause of the Constitution confers broad authority on Congress, that clause imposes a limitation on that authority: laws enacted must be uniform. And while the uniformity requirement permits Congress to account for differences that exist between different parts of the country, it does not give Congress free rein to subject similarly-situated debtors in different States to different fees. In a unanimous decision, the Supreme Court held that the 2017 fee increases were unconstitutional because they violated the uniformity requirement; however, the Court expressly declined to reach the issue of whether the division of districts as between the U.S. Trustee program and the Bankruptcy Administrator program was itself permissible in light of the uniformity requirement of the Bankruptcy Clause.

2. Ad Hoc Comm. of Holders of Trade Claims v. PG&E (In re PG&E Corp.), 46 F.4th 1047 (9th Cir. 2022) NB

PG&E filed chapter 11 in January of 2019 while still solvent to "proactively address massive potential liabilities" arising out of a series of wildfires in Northern California. In connection with confirmation of its plan, the bankruptcy court had agreed with the debtor that trade creditors who were to receive payment in full of the principal amount of their claims and post-petition interest at the federal judgment rate were "unimpaired" within the meaning of Bankruptcy Code §1124 and therefore had no right to vote on the plan. In the view of the bankruptcy court, the holding of In re Cardelucci, 285 F.3d 1231 (9th Cir. 2002) and the text of the bankruptcy code compelled this result. The district court affirmed, but the Ninth Circuit reversed.

As a general rule, unsecured creditors are not entitled to post-petition interest on the amount of their claims, but the objecting creditors argued that there is a common law exception to this rule – the "solvent debtor" exception. This exception, developed by English courts in the eighteenth century and routinely applied by American courts under the Bankruptcy Act of 1898, was designed to prevent the owners of a solvent debtor from reaping the benefit of a surplus from the bankruptcy estate by pocketing money that the debtor had promised to pay to creditors. The creditors argued that, in light of this exception, because PG&E was solvent, they would only be unimpaired if the plan provided for payment to them of post-petition interest at their contractually bargained for rates (or at California's legal rate of 10 percent) rather than at the federal judgment rate of 2.59 percent.

The Circuit distinguished the Cardelucci case on the ground that it was interpreting a statutory provision --section 727(a)(5) -- that comes into play in a chapter 11 case only when it is necessary to ascertain whether a plan satisfies the best interests of creditors test with regard to an ***impaired*** creditor who votes to reject the plan. Under this test, a creditor who does not vote in favor of confirmation must receive at least as much as it would receive in a hypothetical chapter 7 case. Cardelucci tells us that, to satisfy this test, a solvent estate chapter 7 estate must make post-petition interest payments to unsecured creditors at the federal judgment rate. As unimpaired creditors are deemed to have accepted the plan, the best interest of creditors test never comes into play, and, therefore, the reasoning of Cardelucci is inapplicable.

Turning to the language of the Code itself, the Circuit noted that "[n]o provision of the Code specifies the rate of post-petition interest a creditor must receive from a solvent debtor to be unimpaired," and "[t]he Supreme Court has made clear that it "will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." Based on its review of the language that currently appears in the Code, the Circuit found no evidence to support the debtor's contention that the solvent-debtor exception had been abrogated by the passage of the Bankruptcy Code. According to the Circuit, Congress defined impairment in the broadest possible terms such that ***any*** alteration of a creditor's legal, equitable or contractual rights – including the right that would otherwise exist outside of bankruptcy to receive interest at either the contractual rate of interest or the state's legal rate – will constitute impairment. As a result, because PG&E's plan purported to alter this right and pay creditors a lower rate of interest, the objecting creditors were impaired and were entitled to vote on the debtor's plan. The Circuit therefore remanded for a determination of how much post-petition interest the unimpaired creditors should receive. In so doing, the Circuit acknowledged that, although interest should ordinarily be calculated at the contract rate or the state's legal rate in a solvent case, there could be circumstances in which the payment of contractual or default interest could impair the ability of other similarly situated creditors to be paid in full or other "compelling equitable considerations" that would weigh in favor of payment of post-petition interest at a different rate.

3. Barclay v. Boskoski, 52 F.4th 1172 (9th Cir. 2022) MB

In Boskoski, the Ninth Circuit explained how to calculate a debtor's homestead exemption and the limits on the notion that state law determines the homestead exemption to which the debtor is entitled. In this case, the judgment creditor's lien was recorded and therefore attached to the debtor's residence in 2014, at a time when the amount of the homestead exemption available to a debtor under California law was $100,000. In 2021, however, California significantly increased the size of the homestead exemption available to debtors. By the time of the debtor's bankruptcy filing, the amount of the homestead exemption available to the debtor was $600,000.

California Code of Civil Procedure section 703.050(a) provides that the amount of an exemption is determined by the application of the exemption statutes in effect at the time the creditor's judgment lien attached. Therefore, when the debtor moved to avoid the creditor's lien as impairing his homestead exemption, his chapter 7 trustee argued that the amount of the debtor's homestead exemption should be limited to $100.000. The bankruptcy court rejected this argument and avoided the lien in its entirety and certified the issue for a direct appeal to the Circuit. The Circuit affirmed.

In the view of the Court of Appeals, the issue was controlled by the Supreme Court's decision in Owen v. Owen, 500 U.S 305 (1991). In Owen, a Florida debtor sought to avoid a judgment lien that had been recorded before he acquired an interest in his condominium. Under Florida law, a debtor is not entitled to assert a homestead exemption in a property that became the debtor's homestead after a creditor's lien is recorded. The judgment creditor argued that the availability of the debtor's homestead exemption should be determined under state law and, therefore, as the debtor was not entitled to assert a homestead exemption as against this creditor's lien under Florida law, his homestead exemption was not impaired by the existence of the creditor's lien. The Supreme Court disagreed, explaining that the policy of permitting states to define the extent of exemptions is not absolute. It is plainly not true that bankruptcy courts must apply state-defined exemptions along with all of their limitations. Section 522(f) establishes as the baseline against which impairment is to be measured not an exemption to which the debtor *is* entitled, but rather the one to which the debtor *would have been* entitled but for the lien to be avoided. This connotes a state of affairs that is conceived or hypothetical, rather than actual. Therefore, the Bankruptcy Court did not err when it ruled that the debtor was entitled to assert a homestead exemption in the amount that would have been available to him as of the petition date if the judgment creditor's lien had not existed.

Applying this reasoning, the Circuit agreed with the Bankruptcy Court's calculations under Bankruptcy Code section 522(f). The Bankruptcy Court had added the amount of the challenged lien ($477,926.82) to the sum of all other liens against the property ($551,720.47), combined this with the amount of the debtor's exemption ($600.000), and found that the total of these numbers ($1,629,647.20) exceeded by $543,897.20 the value that the debtor's interest in the property would have had in the absence of any liens ($1,085,750). As $543,897.20 exceeded the amount of the challenged lien, it was proper for the bankruptcy court to have avoided the creditor's lien in its entirety.

4. United States v. Warfield (In re Tillman), 53 F.4th 1160 (9th Cir. 2022) DS

In Tillman, the Ninth Circuit reversed a bankruptcy court order avoiding a lien for tax penalties and preserving the value of that lien for the creditors of the estate. The IRS held a lien on the debtor's real property for tax penalties. The debtor filed chapter 7 and claimed a $150,000 homestead exemption in the property under Arizona law. The trustee filed an adversary proceeding to avoid the IRS's lien on the property for the benefit of the estate. The bankruptcy court entered summary judgment for the trustee, and the District Court affirmed. The Ninth Circuit reversed.

The Circuit identified the issue as a matter of first impression – whether a trustee may use Bankruptcy Code sections 724(a) and 551 to avoid and preserve a tax penalty lien on a debtor's exempt property for the benefit of the estate. The Circuit distinguished several prior decisions in which it had permitted this very result on the ground that, in those earlier cases, neither the IRS nor the debtor had opposed the trustee's efforts to avoid the lien. Thus, the relevant issue had never really been addressed.

As the Circuit explained, although the debtor's real property was an asset of the estate at the time the case was commenced, once the debtor claimed an exemption in the property and the trustee did not object in a timely manner, the property ceased to be included in the estate. Therefore, the Circuit reasoned, section 724(a) no longer applied, as that section only permits a trustee to avoid a lien that secures a claim of the kind specified in section 726(a)(4), and section 726(a)(4) provides for "property of the estate" to be distributed in payment of allowed claims for fines, forfeitures and penalties. Therefore, in the view of the Circuit, section 724(a) only permits a trustee to avoid liens for fines and penalties against property of the estate. Because exempt property has been removed from the estate, section 724(a) no longer applies.

But for this result, the debtor would in substance be required to pay the tax penalties twice. Under Bankruptcy Code section 522(c), the debtor's exempt property remains liable for a tax lien for which notice has been properly filed, including liens for tax penalties. Therefore, when a debtor exempts property subject to such a lien, the debtor takes that property subject to the tax penalty lien. If the court were to permit the trustee to avoid the tax penalty portion of a lien against the debtor's exempt property for the benefit of creditors, the debtor would essentially be required to pay the tax penalties twice – once when the value of his exemption was reduced by the tax penalties for the benefit of creditors and a second time when the debtor was required to pay the penalties to the taxing authority because the exempt property remained subject to the lien under section 522(c).

The dissent argues that the majority is, in essence, misreading the plain language of the Code in order to avoid a result that it finds troubling – namely, requiring the debtor to effectively pay the tax penalties twice. In the view of the dissent, nothing in the Code sets aside the trustee's avoidance authority just because the tax penalty lien attaches to exempt property. The dissent rejects the notion that property that has been exempted necessarily ceases to be property of the estate. It is merely immunized against liability for prebankruptcy debts. In the view of the dissent, all property of the debtor as of the filing of the case (subject to certain exceptions) becomes property of the estate including property that may be claimed as exempt. A statute permitting the debtor to claim a particular exemption does not allow the debtor to exempt the entire property interest. It merely permits the debtor to exempt an interest in the property up to a particular dollar amount. Therefore, the rationale used by the majority to avoid what it perceived as a harsh result does not work.

5. Kassas v. State Bar of Cal., 49 F.4th 1158 (9th Cir. 2022) JN

Bankruptcy Code section 523(a)(7) provides that an individual debtor is not discharged from a debt that is (1) for a fine, penalty or forfeiture, (2) payable to or for the benefit of a governmental unit, and (3) not compensation for actual pecuniary loss. The debtor, Kassas, had been disbarred by the California Supreme Court and had been ordered (1) to make restitution payments to 56 clients for a total of $201,706, plus 10 percent interest per annum; (2) to pay costs to the State Bar for his disciplinary proceeding of $61,122.27; and (3) to reimburse the State Bar's Client Security Fund ("CSF") for any amounts that it paid out to Kassas's clients. By April of 2021, including interest and processing fees, Kassas owed reimbursement payments to the CSF totalling more than $2,000,000 for payments that it had made to 356 claimants.

Kassas filed chapter 7 in December of 2019, and, in January of 2021, brought an adversary proceeding seeking a declaration that all of these debts were dischargeable in bankruptcy. The bankruptcy court held that the restitution payments that Kassas was ordered to pay directly to former clients were dischargeable on the ground that they were not payments to a governmental unit. No one appealed this ruling.

Applying the reasoning of In re Findley, 593 F.3d 1048 (9th Cir. 2010), the bankruptcy court held that the costs due the State Bar were excepted from the discharge under section 523(a)(7). Findley had reached this result – overturning its 2001 ruling to the contrary in In re Taggart, 249 F.3d 987 (9th Cir. 2001) – because, after the Ninth Circuit's ruling in Taggart, California amended the statute requiring payment of these costs to specify that such costs are "penalties . . . to promote rehabilitation and to protect the public." Kassas acknowledged that the bankruptcy court judgment concerning these costs was proper under Findley but preserved his right to ask the Circuit to reconsider the holding of Findley in an *en banc* hearing

The main dispute in Kassas therefore was whether the reimbursement payments due the CSF were dischargeable in bankruptcy. No one disputed that the payments were to a governmental unit, but did they satisfy the other two prongs of section 523(a)(7)? The bankruptcy court found that they were not dischargeable in light of the fact that the primary purpose of requiring an attorney to make these payments as a condition to his future practice of law was rehabilitative and not compensatory, but he certified the issue for a direct appeal to the circuit because the judgment involved a matter of pubic importance and a question of law as to which there was no controlling decision from the court of appeals for the circuit.

After carefully considering the process that a claimant must go through in order to obtain payment from the CSF, the Circuit held that it need not consider whether the obligation to repay the fund should be considered in substance a fine or a penalty because it found that the payments at issue were compensation for actual pecuniary loss. At every step of the CSF process, the State Bar is focused on compensating victims for their actual pecuniary losses or seeking compensation for the amount the CSF actually paid to victims as compensation. The attorney's obligation is to reimburse the fund for all moneys that it actually pays out. And the State Bar is then subrogated to the extent of the payment it makes from the fund to the victim's claims against the attorney. Therefore, any debt that Kassas owed his clients to cover the losses that they suffered as a result of his misconduct, whether directly or by way of reimbursement to the fund, does not qualify as nondischargeable under section 523(a)(7). (Depending on the facts and circumstances however, amounts due the debtor's former clients might be nondischargeable under a different subsection of 523(a).)

6. Baroni v. Seror (In re Baroni), 36 F.4th 958 (9th Cir. 2022) HB

The chapter 11 debtor, Baroni, confirmed a plan under which she was required, among other things, to deposit monthly payments into separate reserve accounts for two secured creditors while she litigated the validity of their secured claims. If her challenge to either claim failed and the creditor's claim was allowed, she was required to transfer the funds deposited into the reserve account for that creditor to the creditor within 10 days and to commence making monthly payments to the creditor on account of its allowed claim. The debtor brought adversary proceedings against these lenders--Bank of New York Mellon and Wells Fargo. Three years later, she lost her challenge against Wells Fargo, but refused to turnover its reserve account or to begin making monthly payments to it. The debtor finally relented after Wells Fargo filed a motion to convert, and the bankruptcy court denied the motion to convert as moot.

A year later, the debtor lost her challenge to Bank of New York Mellon's claim and again refused to turnover the reserves or to start making payments. After a few months of arguing with the debtor, Bank of New York Mellon filed its own motion to convert the case to chapter 7. The bankruptcy court found that the debtor had materially defaulted under the plan and converted the case. The debtor eventually complied with the chapter 7 trustee's demand that she turn over all funds in Bank of New York Mellon's reserve account but the debtor refused to comply with the trustee's demand that she turn over rents and sales proceeds generated by her rental properties, arguing that they had revested in her upon confirmation and were no longer assets of her bankruptcy estate. The Bankruptcy Court rejected this argument and ordered the turnover of the disputed assets. The debtor appealed both the conversion and the turnover orders.

In deciding whether Bank of New York Mellon had carried its burden of proof in connection with the conversion, the Circuit observed that "cause" includes "a material default by the debtor with respect to a confirmed plan" and that a failure to make plan payments can qualify as a material default, even if the plan has been substantially consummated and the debtor has made many of the plan payments, depending on the number of missed payments, the number of aggrieved creditors and how long the default continued. Here, as the debtor had been in default under the plan for at least six months with a past due amount of at least $200,000, representing five years' worth of payments, the debtor's default qualified as material. And the Circuit rejected the debtor's argument that her ability to cure the default promptly amounted to "unusual circumstances" that made conversion of her chapter 11 case inappropriate. Lastly, the Circuit turned to the issue of revesting and held that, although the Bankruptcy Code is silent as to what constitutes the bankruptcy estate when a case is converted to chapter 7 after plan confirmation, Ninth Circuit case law dictates that the effect of conversion should be determined by an examination of the confirmed plan. The plan need not explicitly state that assets revest in a converted chapter 7 case for this to occur. The central question is whether the plan's language, purposes and context changed the effect of the general vesting provisions of section 1141 after conversion to chapter 7. A bankruptcy court should undertake a holistic analysis of the plan to determine whether its vesting provisions deviate from the default vesting rule in section 1141(b). Here, there was no plan provision that expressly dealt with the issue of estate property after conversion, but the premise of the plan was to pay creditors with the ongoing income stream generated by the rental properties that were the subject of the dispute and this stream was earmarked for payments to creditors. Therefore, to hold that the unadministered rent and sale proceeds did not revest in the bankruptcy estate upon conversion to chapter 7 would frustrate the intent of the plan and be contrary to many of its provisions. The Circuit thereafter affirmed the bankruptcy court's order directing that the debtor turn these assets over to the chapter 7 trustee.

7. County of San Mateo v. Chevron Corp., 32 F.4th 733 (9th Cir. 2022) EH

In July of 2017, San Mateo County, Marin County and the City of Imperial Beach filed similar complaints in state court against more than 30 energy companies. Shortly thereafter, the County and City of Santa Cruz and the City of Richmond filed similar complaints. The complaints asserted claims under state law for public and private nuisance, failure to warn, strict liability for design defect, negligence, negligent failure to warn and trespass based on allegations that the energy companies' extraction, refining and/or formulation of fossil fuel products, the introduction of fossil fuel products into the stream of commerce, their wrongful promotion of fossil fuel products, their concealment of known hazards associated with the use of these products and their failure to pursue less hazardous available alternatives had been a substantial factor in causing the increase in global mean temperature and sea level rise, resulting in injuries and damages to real property and improvements that have already occurred and that will foreseeably continue to occur. The energy companies responded by removing the actions to federal court, asserting several bases for federal jurisdiction: (1) the claims asserted raise disputed and substantial federal issues; (2) the plaintiffs' claims were completely preempted by federal law; (3) the claims arose on "federal enclaves"; (4) the claims arose out of operations on the "outer Continental Shelf"; (5) the claims arose out of actions taken at the direction of a "federal officer"; and (6) the claims were related to the bankruptcy cases of certain of the energy companies. The Circuit rejected all of these arguments and affirmed the District Court's decision to remand the actions to state court.

This decision was actually the second opinion by the Circuit with regard to the issue of remand in these cases. In the first appeal, the Circuit had considered only the question of whether subject matter jurisdiction existed under the federal officer removal statute and had dismissed the balance of the appeal for lack of appellate jurisdiction pursuant to 28 U.S.C. section 1447(d), which generally prohibits review of orders remanding matters to state court. (An earlier decision by the Circuit had created an exception to this prohibition for the review of remand of removals under the federal officer removal statute.) While the energy companies' appeal of this decision was pending before the Supreme Court, that court issued its decision in BP p.l.c. v. Mayor & City Council of Baltimore, 141 S. Ct. 1532 (2021), which permitted appellate review of defendant's remaining grounds for removal. The Supreme Court therefore vacated and remanded the Circuit's earlier opinion for further consideration in light of Baltimore.

On remand, the Circuit thoroughly discussed, and rejected, each of the bases for federal removal jurisdiction asserted by the energy companies. On the subject of bankruptcy removal, the Circuit notes that the scope of bankruptcy jurisdiction is significantly more narrow after confirmation of a chapter 11 plan. After confirmation, a matter falls within the bankruptcy court's subject matter jurisdiction only if there is a "close nexus" to a bankruptcy case or proceeding. As a general rule, proceedings that merely require the court to read a confirmed plan to determine whether it bars certain claims that arose before confirmation, and do not require any resolution of disputes over the meaning of the plan's terms, are not proceedings affecting the interpretation or implementation of a plan and therefore do not satisfy the close nexus test. Here, the defendants argued that the district court would have to interpret disputed language in a plan confirmed by one of the defendants a few months before the complaints were filed. But the reorganized debtor had already filed an action in bankruptcy court that had resolved any undisputed issues concerning the terms of one of the two plans that appellants claimed needed to be interpreted and they were unable to point to any provision of the other plan – a plan confirmed by Texaco in 1988 – that would need to be interpreted in order to resolve these actions. Therefore, the Circuit found that the litigation lacked a sufficiently close nexus to give rise to post-confirmation bankruptcy jurisdiction.

8. Harrington v. Mayer (In re Mayer), 28 F.4th 67 (9th Cir. 2022) MRB

In Ritzen Grp., Inc. v. Jackson Masonry, LLC, 140 S. Ct. 582 (2020), the Supreme Court held that, under the more relaxed rules of finality in bankruptcy cases, the adjudication of a motion for relief from the automatic stay forms a discrete procedural unit within the larger bankruptcy case and that an order resolving such a motion yields a final, appealable order when the bankruptcy case unreservedly grants or denies relief. In Mayer, the Circuit took this analysis one step farther and held that even an order denying relief from stay *without prejudice* can be a final, appealable order where it conclusively resolved the issue of whether a nondebtor would ever be able to go into state court to adjudicate his claims against the debtor.

In Mayer, the debtor and Harrington had formed two real estate businesses together. Eventually, disagreements arose and the two and their families became embroiled in litigation in state court in Massachusetts. Among the actions pending at the time the bankruptcy was filed was a counterclaim by Harrington against the debtor for breach of fiduciary duty, breach of contract, fraudulent misrepresentation and other violations of Massachusetts law. When Mayer filed chapter 7, Harrington filed a 523/727 action against him and moved for relief from stay to prosecute his claims against Mayer in state court.

Mayer's chapter 7 trustee entered into an agreement with Harrington, pursuant to which the estate would receive a percentage of the recoveries that Harrington generated from the claims he had asserted against Mayer, including the claim that Mayer had fraudulently transferred assets into an exempt trust. The bankruptcy court wanted additional information about the claims being compromised before it would approve the proposed settlement. The bankruptcy court therefore granted limited relief from stay to permit the parties to depose one another in the state court actions and repeatedly continued the hearing on the balance of the stay relief requested by Harrington. Eventually, the bankruptcy court denied Harrington's motion for relief from stay without prejudice, but, in the course of so doing, made clear on the record that it "unreservedly denied relief." At the hearing at which it denied relief from stay, the Court stated, "if the only purpose for your motion to stay relief is to go back [to the Massachusetts court] as to . . . Mayer-related issues that are being dealt within the 727 action and the 523 action, then no, you're not getting relief from stay [for] that." The Court stated further that "this matter is now ready for trial on the nondischargeability complaint in the [bankruptcy court] and should be scheduled for same." Therefore, it was clear on these facts that, even though the order denying relief from stay said on its face that it was "without prejudice," it conclusively resolved the discrete issue of whether Harrington could obtain relief from stay to proceed against Mayer in state court. It denied the motion "without prejudice" merely to indicate that the court was willing to consider stay relief if it were sought for a different purpose. Therefore, the order was final and appealable notwithstanding the inclusion of language indicating that it was without prejudice.

The District Court had denied Harrington's motion for leave to appeal on the ground that the order was not final and appealable. The Circuit reversed this order, authorizing the appeal to proceed, but, in a separate memorandum, disposed of that appeal by finding that it was not an abuse of discretion for the bankruptcy court to have denied Harrington relief from stay. The Circuit therefore remanded the matter to District Court with instructions to affirm the bankruptcy court's order denying relief from stay.

9. <u>NetJets Aviation, Inc. v. RS Air, LLC (In re RS Air, LLC)</u>, 638 B.R. 403 (B.A.P. 9th Cir. 2022) VK

In <u>RS Air</u>, the BAP answered at least two previously unanswered questions concerning subchapter V. The debtor, RS Air, was an entity formed by its sole member and manager, Stephen Perlman, for the purpose of using and providing aircraft transportation services for fragile technology prototypes, acquiring and selling fractional interests in aircraft and providing depreciation tax benefits to Perlman. Most or all of RS Air's contracts and leases were with a private jet charter business known as NetJets. After several years of doing business together without incident, trouble ensued. According to RS Air, one of the jets in which it owned a fractional interest was involved in a crash due to the fault of a NetJets pilot, and NetJets failed to disclose the incident to RS Air. At that point, the two companies ceased doing business together and sued one another in state court. Just before trial was set to begin, RS Air filed chapter 11 in California and elected to proceed under subchapter V. By that point, RS Air had ceased operating (which RS Air blamed on its disputes with NetJet) and had no revenue or income and no employees; however, it was still engaged in the following activities: (1) litigating with NetJets; (2) negotiating with NetJets to sell its fractional jet interests back to NetJets; (3) paying its aircraft registry fees; (4) remaining in good standing as a Delaware LLC; (5) filing tax returns; and (6) paying taxes due to the State of California and the federal government. According to RS Air, it intended to resume normal flight operations with a different partner once it was able to do so. NetJets objected to the debtor's subchapter V election, arguing that RS Air was not currently engaged in commercial or business activities and had never been a revenue generating entity, its sole purpose being to serve as an intermediary through which Perlman acquired interests in and paid for the availability and use of private jets. The bankruptcy court held that the party objecting to a subchapter V election bears the burden of proof and found that NetJets had failed to carry its burden of proof. NetJets renewed its objection to RS Air's eligibility to proceed under subchapter V at plan confirmation, but the bankruptcy court found that the law-of-the-case doctrine precluded it from revisiting the issue of RS Air's eligibility to proceed under subchapter V. The bankruptcy court confirmed the debtor's plan, and NetJets appealed.

The BAP held that the debtor bears the burden of proving its eligibility to proceed under subchapter V and not the creditor objecting to the election; however, it found that the debtor had carried this burden and was eligible to proceed as a subchapter V debtor, making the bankruptcy court's ruling on the burden of proof a harmless error of law. In the view of the BAP, the debtor need not be "actively operating" a business on the petition date, but must, at the time the petition is filed, be engaged in commercial or business activities. The definition of what constitutes commercial or business activities is very broad and requires an examination of the totality of the circumstances, but the debtor need not be engaged in a for-profit business to fall within this definition. Based on the plain and unambiguous language of the statute, no profit motive is required; dealings or transactions of an economic nature are sufficient to constitute commercial or business activities, and the BAP found that RS Air's activities constituted dealings or transactions of an economic nature.

With regard to the bankruptcy court's ruling with regard to the law of the case doctrine, the BAP noted that there are exceptions to this discretionary doctrine and that it is permissible for a bankruptcy court to revisit a prior ruling when (1) its earlier decision was clearly erroneous; (2) an intervening change in the law has occurred; (3) the evidence presented in the later proceeding is substantially different; (4) other changed circumstances exist; or (5) a manifest injustice would otherwise result. But the BAP saw no reason for Judge Hammond to have revisited her earlier ruling on eligibility as the "new evidence" that NetJets wanted to introduce merely supported the fact that RS Air had no net profit, and she had correctly found that the absence of profit or a profit motive does not render a debtor ineligible to proceed under subchapter V.

10. Legal Serv. Bureau, Inc. v. Orange Cty. Bail Bonds, Inc. (In re Orange Cty. Bail Bonds, Inc.), 638 B.R. 137 (B.A.P. 9th Cir. 2022) MM

The debtor was a small bail bond company that owed several hundred thousand dollars to Global, a company that it had hired to locate and return to the US one of the defendants for whom it had issued a bond. The debtor held a deed of trust against the defendant's parents' home as security for the bond. Global sued the debtor to recover amounts due. The debtor attempted to foreclose on the parents' house, but encountered a number of obstacles, including a chapter 13 filing by the defendant's mother. To make matters worse for the debtor, the California legislature passed SB10, which significantly reduced the need for cash bail and therefore bail bonds. Unable to pay amounts due Global, the debtor filed chapter 11 in June of 2019. Global's claim represented approximately 95 percent of the debtor's noninsider unsecured debt, and its largest asset was its deed of trust against the parents' home. Shortly after the legislation creating subchapter V became effective, the debtor elected to proceed under subchapter V and filed an amended plan and disclosure statement. Global responded by filing a motion to dismiss or convert, arguing that the case had been filed in bad faith and that the debtor would be unable to reorganize due to its continuing losses. The court set a continued hearing on the dismissal motion and the debtor's disclosure statement for a date after the November 2020 election to see whether a referendum on the ballot that would repeal SB10 would pass, which it did.

The bankruptcy court later continued the hearing on the dismissal motion to the date of the confirmation hearing. The BAP agreed that this made sense, citing In re Marshall, 721 F.3d 1032 (9th Cir. 2013), for the proposition that a debtor's showing that a plan of reorganization is ready for confirmation essentially refutes a contention that the case is filed or prosecuted in bad faith. By the time of the confirmation hearing, the debtor had foreclosed upon and sold the parents' house and filed a third amended plan under which the debtor would pay Global cash on the effective date of almost $128,000 and pay all of its *actual* (and not projected) disposable income to unsecured creditors over a five-year period after confirmation. In addition, the plan provided that, unless Global received a minimum of $181,000 in payments over the life of the plan, the debtor would not receive a discharge. The bankruptcy court confirmed the plan as a nonconsensual plan under section 1191(b) and denied Global's motion to dismiss or convert. Global appealed.

Disagreeing with the bankruptcy court, the BAP held that the plan did not satisfy the fair and equitable requirement of section 1191(c)(2)**(A)** because it did not provide for all of the debtor's *projected* disposable income over the commitment period to be paid to creditors and instead obligated the debtor to pay only its *actual* income during this period; however, the BAP found that the plan *did* satisfy the requirements of section 1191(c)(2)**(B)** because it provided for the distribution to creditors of property under the plan (namely, the full amount of the sale proceeds from the parents' house) of a value greater than the debtor's projected disposable income for a 3-year period. (Notably, the court had never required the debtor's plan to have a 5-year commitment period: the debtor had agreed to a 5-year period to obtain the support of the subchapter V trustee.) The BAP also affirmed the bankruptcy court's determination that the plan was feasible even though the debtor had suffered continuing operating losses during the case because the debtor's plan projections were based on the debtor's historical performance prior to the adoption of SB10 and the COVID-19 pandemic. Moreover, the plan would succeed even if the debtor did not meet its projections, because it called for payments of actual rather than projected income. The debtor would not receive a discharge if it did not generate enough disposable income to pay Global the required minimum payment, but that would not result in a plan default. (The BAP apparently disregarded the fact that, if the debtor did not receive a discharge of the unpaid portion of its debts, it might well have a need for further liquidation or reorganization.)

11. Masingale v. Munding, 644 B.R. 530 (B.A.P. 9th Cir. 2022) NB

The Masingales filed chapter 11 in 2015 and claimed a homestead exemption in their home for "100% of FMV [fair market value]." No one objected. At that time, the debtors claimed that the property was worth $165,430 and that the property secured a debt for $130,724. During the pendency of the case, Mr. Masingale died, and Mrs. Masingale confirmed a chapter 11 plan under which she was to retain her home and pay secured claims in full. Eventually, Mrs. Masingale defaulted on her plan payments and, over a year after confirmation, the case was converted to chapter 7 and a trustee was appointed.

Mrs. Masingale moved to compel the trustee to abandon her home, which was, by then, worth more than $400,000, arguing that the full value of the property was exempt because no one had objected to the exemption she had claimed in a timely manner. (And it was too late for the chapter 7 trustee to object to the debtor's exemptions because, under Bankruptcy Rule 1019(2)(B)(i), there is no new opportunity to object to an exemption if the case is converted to chapter 7 more than a year after plan confirmation.) The chapter 7 trustee opposed the motion to abandon and argued that the debtor's exemption was fixed at the amount of equity in the property that existed as of the petition date. The bankruptcy court agreed, denied the debtor's motion to compel abandonment and authorized the trustee to sell the debtor's home. The bankruptcy court held further that the increase in the home's equity that occurred during the pendency of the case belonged to the bankruptcy estate under Bankruptcy Code section 541(a). Nevertheless, on the debtor's motion, the bankruptcy court directed the trustee to retain the undisbursed portion of the sale proceeds pending the outcome of the debtor's appeal of its sale order.

The BAP first rejected the trustee's argument that the debtor's appeal was moot either statutorily and/or equitably because (1) the debtor was not seeking to overturn the sale and merely sought to recover the net proceeds; (2) a significant portion of the net sales proceeds remained undisbursed; and (3) even if the trustee had fully disbursed the net proceeds of sale, he had not shown that it was impossible or inequitable for him to "claw back" any sale proceeds that he had disbursed. Next, the BAP reversed the bankruptcy court's ruling that the debtor's homestead exemption was limited to the amount of equity that existed as of the petition date. Applying the reasoning of Taylor v. Freeland & Kronz, 503 U.S. 638 (1992), the BAP held that, if no one files a timely objection, an exemption claim is valid, even if it had no "colorable basis" in the law. And the trustee is not entitled to a different result merely because he had not been appointed until after the opportunity to object was long gone. There were other parties in interest at the time who could have objected in a timely manner but failed to do so. Lastly, the BAP held that the debtors had successfully exempted the entirety of their home's fair market value from the estate. Applying the Supreme Court's ruling in Schwab v. Reilly, 560 U.S. 770 (2010), the BAP reasoned that, if the debtor had claimed an exemption in a specific dollar amount – even if, at the time the petition was filed, that dollar amount equaled the full amount of the existing equity in the property – the debtor would be limited to the dollar amount of the exemption that she had claimed on her Schedule C. But here, where the debtor had put parties in interest on notice that she intended to claim the full value of the property as exempt -- even though she had no right to do so under then applicable law -- because no one objected in a timely manner, the debtor is entitled to the full market value of the property, including all post-petition appreciation. In its conclusion, the BAP notes that improperly claiming exemptions in the hope that no one will object is "risky at best" and that the court may impose penalties against parties and attorneys who make assertions that lack any colorable basis or engage in improper or bad faith conduct. So you may not want to try this at home.

12. <u>Spark Factor Design, Inc. v. Hjelmeset (In re Open Med. Inst.)</u>, 639 B.R. 169 (B.A.P. 9th Cir. 2022) MB

OMI, a medical research company, filed chapter 7. Kogelnik had previously owned 100% of OMI, but, by the petition date, owned only 5 percent of the company. Kogelnik claimed he had been forced out as CEO and director by two entities from whom OMI had borrowed money: Spark Factor and Working Dirt. Spark and Dirt claimed that the board had forced Kogelnik to resign due to his misconduct including gross mismanagement and misappropriation of assets for his personal benefit. However, Spark and Dirt had been up to shenanigans of their own, including assigning a valuable lease previously held by OMI – and the right to the related security deposit of $1.9 million – to Spark. Kogelnik filed a $1.35 million claim in OMI's bankruptcy case based on prepetition loans, and OMI's trustee asserted various litigation claims against Spark, Dirt and their principals (collectively, the "Targeted Parties"). Kogelnik filed chapter 11, and OMI's trustee filed a proof of claim for breach of fiduciary duty in his bankruptcy case. Spark and Dirt filed 523 and 727 actions against Kogelnik.

OMI's trustee and Kogelnik eventually negotiated a settlement of the disputes between OMI's estate and Kogelnik, and the trustee filed a 9019 motion. (Kogelnik filed a similar motion in his chapter 11 case.) Under that settlement, the trustee would release all of OMI's claims against Kogelnik and withdraw his proof of claim in Kogelnik's case; a nondebtor entity controlled by Kogelnik (Basis) would buy OMI's claims against the Targeted Parties (the "Litigation") for $200,000 and 55% of the net recoveries that the Litigation generated; Basis would pursue the Litigation at its own expense; and Kogelnik would subordinate his claims in the OMI case to allowed noninsider claims. In his motion, the trustee explained that it was his business judgment that the sale of the Litigation should be treated as a private sale not subject to overbid, because the only parties likely to overbid were the Targeted Parties themselves, and they lacked any incentive to prosecute the Litigation. However, if the court were to permit the Targeted Parties to overbid, the trustee requested that the overbid be not less the $200,000 in cash that Basis had agreed to pay and an additional $3,170,000, representing the minimum recovery that the trustee believed the 55% participation offered by Basis would generate. Spark and Dirt objected, arguing, among other things, (1) that the proposed compromise was a sale that required analysis under section 363; (2) that the compromise failed to satisfy the A&C Properties factors; (3) that their competing bid – to pay $300,000 in cash and 100% of the recoveries that they generated by prosecuting at their own expense claims that the trustee planned to release against Kogelnik – was worth more than the consideration that Kogelnik and Basis had offered in exchange for the Litigation; and (4) it was unfair to require them to pay more than $3 million in order to overbid. The bankruptcy court overruled these objections and granted both compromise motions.

Although the BAP lamented that the trustee did not provide more support for his analysis of the claims and settlement, it found that (1) it was not an abuse of discretion for the bankruptcy court to have approved the compromise and (2) the bankruptcy court properly analyzed the compromise as a whole and did not need to evaluate the transfer of the Litigation separately. The BAP distinguished this case from <u>In re Mickey Thompson Ent. Grp.</u>, 292 B.R. 415 (9th Cit. BAP 2003) on the ground that, in this case, the trustee and Kogelnik had claims against each other -- the transfer of the Litigation was only one element of an integrated transaction settling mutual claims. The BAP also observed that the bankruptcy court need not defer to the wishes of objecting creditors merely because those creditors hold the majority of the claims in the bankruptcy cases and that bankruptcy courts have discretion to refuse to allow overbids based on the dynamics of a particular situation. Judge Spraker wrote a concurring opinion in which he advanced the view that the bankruptcy court *was* required to consider the transfer of the litigation claims as a sale under section 363, but that the bankruptcy court had adequately done so in response to the compromise motions.

13. Guevarra v. Whatley (In re Guevarra), 638 B.R. 120 (B.A.P. 9th Cir. 2022) DS

The debtor's schedules reflected a joint interest in real property and a secured claim against that property, but did not claim an exemption in the property of any kind. The debtor advised the trustee that he had merely co-signed the loan for his nephew, did not live at the property, had not paid any portion of the purchase price and, as a result, had no equitable interest in the property. The trustee nevertheless filed a motion to sell the debtor's one-half interest in the property free and clear of the nephew's equitable interest. The basis for this request was the trustee's contention that the estate could sell the property "free of a prior equitable interest or constructive trust interest" in the property by virtue of the trustee's avoiding power rights under section 544(b). The motion also included a representation that, if a court of competent jurisdiction found that the bankruptcy estate did not have an interest in the property, the trustee would return the sale proceeds.

After the sale closed, the debtor amended his schedules to assert a wild card exemption in most or all of the net sales proceeds. The trustee objected, claiming that the debtor had acted in bad faith and was estopped from claiming an interest in the property in light of his having argued throughout the case that he did not have any interest in the property. The debtor opposed this objection and cited California case law for the proposition that he held title to one-half of the property in a resulting trust for his nephew. See, e.g., Johnson v. Johnson, 192 Cal. App. 3d 551 (1987) (a transferee of property who does not pay the purchase price for the property is presumed to hold the property in a resulting trust for the party who paid the consideration). The bankruptcy court denied the amended exemption on the ground that California law requires exemptions to be claimed in good faith for the benefit the person claiming the exemption. In an earlier appeal, the BAP rejected this interpretation of California law and directed the bankruptcy court to consider the trustee's equitable estoppel argument.

On remand, the bankruptcy court sustained the trustee's equitable estoppel objection. The BAP reversed again. As the BAP explained, debtors have a right to amend their exemptions at any time before the case is closed, and, as we know from Law v. Siegel, bankruptcy courts have no equitable authority under *federal law* to restrict this right based on a perception of bad faith. However, under *California law*, a bankruptcy court may invoke equitable estoppel to prevent the amendment of an exemption if the objecting party can show: (1) a representation or concealment of material facts; (2) made with knowledge of the facts; (3) to a party ignorant of the truth; (4) with the intention that the ignorant party act on it; and (e) that the party was induced to act upon. Here, however, the debtor never concealed any facts or made any misrepresentations and had given the trustee legal authority to support his contention that he held the property in a resulting trust. The trustee had been well aware at all times of the debtor's position and of the basis for that position, as evidenced by the manner in which the motion to sell was worded. And a mere failure to claim an exemption in an asset, without more, does not constitute a misrepresentation or concealment for purposes of equitable estoppel, even if the trustee, in reliance upon the debtor's failure to claim an exemption, expends estate resources to administer an asset. The debtor never denied that he held a joint legal interest in the property. He merely argued consistently that he had no equitable interest in the property because he never occupied the property and his nephew had made all of the payments. He disclosed these material facts to the trustee "early and often." According to the BAP, no reasonable trier of fact could have found that the debtor misled the trustee as to any of the operative facts. The parties merely had a dispute as to the legal implications of those facts. Denying the debtor the ability to amend his exemptions after the court rules against him as to the nature of his interest in the property would amount to penalizing the debtor for raising an unsuccessful legal argument. The BAP therefore rejected the trustee's equitable estoppel argument.

14. Reed v. Reed (In re Reed), 640 B.R. 932 (B.A.P. 9th Cir. 2022) JN

The BAP published this decision, it explained, to clarify that a bankruptcy discharge has no effect on a foreclosure judgment in a California judicial foreclosure proceeding (other than to eliminate the debtor's personal liability for any deficiency judgment).

The debtors borrowed money and executed a deed of trust on their home to secure the loan. When the debtors defaulted, the beneficiary brought a judicial foreclosure action under the deed of trust. The state court entered a default judgment in the lender's favor and entered a form judgment that said, "Defendant . . . must pay plaintiff on the complaint" a total of $331,002.25. An attached judgment of foreclosure and order of sale provided that, in addition to the monetary damages, the property was to be sold and the levying officer was to pay the judgment amount to the lender and any surplus to the debtors.

The debtors later filed chapter 7 and scheduled the judgment debt as an unsecured nonpriority claim. They received their discharge and the case was closed. The state court found the original judgment defective as it contained the wrong post-judgment interest rate but issued a new judgment foreclosing on the property and ordered the sale of the property and the application of the proceeds to the amount due the lender, with any surplus to be paid to the debtors. A few days before the scheduled foreclosure, the debtors filed a new chapter 7 case and moved in their prior case for the issuance of an order to show cause why the lender should not be held in contempt for his violation of their discharge injunction. The debtors advanced the argument that the lender's judgment was an in personam money judgment that had been discharged in their first bankruptcy case because it directed the payment of a particular dollar amount that the judgment creditor was then authorized to collect through a levy. The bankruptcy court rejected both the argument that the mention of a dollar amount in the judgment transformed it into a money judgment and the argument that the issuance of a judgment for judicial foreclosure had transformed the deed of trust into a judicial lien. The BAP affirmed the bankruptcy court and characterized the debtor's position as "frivolous."

A bankruptcy discharge affects only the debtor's personal liability. It does not affect a creditor's in rem rights, such as a lien created by a deed of trust. Valid liens that have not been disallowed or avoided survive the discharge of the underlying debt. The foreclosure judgment, although it involves a monetary amount, is for the purpose of enforcing the creditor's security interest through foreclosure. It is quasi in rem. The monetary amount merely establishes the bid parameters for the foreclosure sale. A security interest does not become a judicial lien upon the issuance of a judgment of judicial foreclosure. While the claim may merge into the judgment, the judgment creditor's security interest remains intact unless the judgment expressly cancels or avoids it. And, for good measure, the BAP also rejected the debtors' one-form-of-action rule argument, and not merely because the debtors failed to raise it below. As the BAP explained, the lender here did exactly what the one-action rule requires: he brought a single action to recover the debt and foreclose the deed of trust. Therefore, the lender did not violate the discharge injunction by moving forward with his efforts to liquidate his collateral, and the BAP affirmed the bankruptcy court's decision to deny the debtors' motion for contempt and sanctions.

15. TICO Constr. Co. v. Van Meter (In re Powell), 644 B.R. 181 (B.A.P. 9th Cir. 2022) HB

The debtor's former employer, TICO, obtained a judgment against him for misappropriation of trade secrets and recorded an abstract of that judgment against property that the debtor (Powell) owned in Nevada. Powell responded by filing chapter 13. At the time Powell filed his petition, the eligibility limit for a chapter 13 debtor's noncontingent unliquidated, unsecured debts was $419,275. Powell scheduled secured debts of $789,501.44, which included $215,629.86 of TICO's judgment, and unsecured debts of $87,000 (which included $53,129.86 as the deficiency portion of TICO's claim). He also scheduled 12 additional unsecured claims in "unknown" amounts.

TICO filed a nondischargeability action in the case and a motion to value its collateral and objected to the debtor's homestead exemption. It also claimed that Powell was ineligible to be a chapter 13 debtor in light of the amounts due under the prepetition judgment and that he had transferred all of his nonexempt assets to his former spouse pursuant to a property settlement in a "sham" divorce. In TICO's view, the filing of the chapter 13 case was abusive. Having lost his enthusiasm for the prospect of being in bankruptcy due to the actions taken by TICO, Powell filed a motion for a voluntary dismissal of his chapter 13 case under Bankruptcy Code section 1307(b). TICO opposed the motion to dismiss and urged the bankruptcy court to convert the case to chapter 7 or 11 instead. TICO argued that conversion was in the best interest of creditors as it would prevent Powell from dissipating estate assets. Powell responded that, even if TICO were correct that he had acted in bad faith, he was still entitled to dismiss his case as of right under In re Nichols, 10 F.4th 956 (9th Cir. 2021). The bankruptcy court agreed with the debtor and dismissed the case. The BAP affirmed.

The BAP noted that, although there is a split of authority in other parts of the country over whether a debtor has an absolute right to dismiss a case or whether bad faith or abuse of the bankruptcy process can preclude voluntary dismissal, the Ninth Circuit in Nichols made clear that chapter 13 debtors have an absolute right to dismiss their bankruptcy cases at any time, so long as their case has not been previously converted from another chapter. There is nothing in the language of section 1307(b) that limits this absolute right to dismiss to only "eligible" debtors. Therefore, under the reasoning of Law v. Siegel, the bankruptcy court lacks the authority to create another exception to this section. Even a debtor who is not eligible to file chapter 13 in the first place has an absolute right to dismiss his chapter 13 case.

If the bankruptcy court is persuaded that the debtor was acting in bad faith or abusing the bankruptcy process by filing under a chapter for which he is ineligible, the bankruptcy court has other tools to address such abuse, such as imposing a bar on refiling or imposing other conditions under section 105, but it may not refuse to dismiss the case at the debtor's request, even if the debtor had no business filing chapter 13 in the first place.

16. Censo, LLC v. Newrez, LLC (In re Censo, LLC), 638 B.R. 416 (B.A.P. 9th Cir. 2022) EH

Pengilly borrowed money from Bank of America to buy a condo in Las Vegas and gave the bank a deed of trust against the property. He then defaulted on his HOA assessments and the HOA foreclosed. KAH bought the property at the foreclosure sale; KAH transferred the property to KAH II; and KAH II transferred the property to Censo. KAH, KAH II and Censo were all managed by the same person. Pengilly sued the HOA and KAH in state court to have the foreclosure sale set aside as unlawful. Censo brought cross-claims for quiet title and for a declaration that foreclosure by the HOA had extinguished the bank's deed of trust (the "Lien"). The case was removed to District Court, and the servicer cross-claimed for a declaration that the Lien was not affected by the foreclosure. Censo responded by filing chapter 11.

After the petition was filed, the District Court entered an order summarily adjudicating that KAH had taken title to the condo subject to the Lien (the "District Court Order"). A few months later, Censo filed an adversary proceeding against the servicer and the lender, seeking disallowance of the secured claim based on errors in the deed of trust. The servicer moved to dismiss the adversary proceeding, arguing that Censo's claims were barred by the District Court Order and that the defects in the deed of trust were insufficient to invalidate it. The bankruptcy court agreed, dismissed the adversary proceeding based on claim preclusion and for failure to state a claim and denied leave to amend. Censo appealed.

On appeal, Censo argued for the first time that the District Court order was void, as it had been entered in violation of the stay, and abandoned the remainder of the arguments it had advanced below. The BAP noted that, ordinarily, federal appellate courts will not consider issues not raised below, but that there are exceptions to this rule. An appellate court may consider an issue for the first time on appeal if (1) there are exceptional circumstances that explain why the issue was not raised below; (2) the new issue arises while the appeal is pending because of a change in the law; or (3) the issue presented is purely one of law and the opposing party will not suffer prejudice if the issue is considered. The BAP found that the issue that Censo raised in this case was indeed a purely legal issue and that the servicer would not be prejudiced by consideration of this issue as the servicer had briefed the issue on appeal and could seek retroactive relief from stay if the BAP were to conclude that a stay violation had occurred.

The BAP then went on to conclude that entry of the District Court's order had not violated the automatic stay because the automatic stay does not bar claims brought by a debtor, and the servicer's claims were asserted by way of defense in response to KAH's assertion that the servicer held no interest in the property. The servicer's counterclaims never would have been filed but for the fact that the debtor's predecessor, KAH, brought the servicer into the litigation by filing a cross-complaint against it. Therefore, the BAP concluded that the stay of section 362(a)(1) had not been violated by entry of the District Court's order. With regard to section 362(a)(3), citing City of Chicago v. Fulton, 141 S. Ct. 585 (2021), the BAP held that entry of the District Court order did not violate the stay because it did not change the status quo and that, "Acts that simply maintain the status quo do not violate the automatic stay." As the servicer's lien existed as of the petition date and the District Court Order simply affirmed the existence of the lien and did not affect KAH's possession or control of the property, entry of the order did not violate the automatic stay. Moreover, the order did not violate sections 362(a)(4) or (a)(5) because it was not an act to create, perfect or enforce a lien. A debtor cannot simply proclaim a stay violation. It must carefully analyze and apply the specific subsection of 362(a) that it contends was violated. Therefore, it was not an abuse of discretion for the bankruptcy court to dismiss the debtor's action without leave to amend.

17. Kurtin v. Ehrenberg (In re Elieff), 637 B.R. 612 (B.A.P. 9th Cir. 2022) MRB

After having been business partners for a number of years, the debtor and Kurtin had a falling out. In 2003, Kurtin sued the debtor under several different theories including breach of fiduciary duty, conversion, and embezzlement. The debtor countersued, asserting similar claims against Kurtin. In 2005, the parties resolved this litigation with a settlement agreement under which Kurtin was to transfer to the debtor his interests in entities that the two had owned jointly (the "Entities"), and the debtor was to pay Kurtin $48.8 million in four installments. The debtor and the Entities were jointly liable for the first $21 million payment. Only the Entities were liable the balance of the payments. The agreement gave Kurtin a security interest in assets owned by the Entities to secure the payments due and prohibited the debtor from taking distributions from the Entities that would cause them to be unable to make the settlement payments.

The first two installments were paid, but the Entities failed to pay the full amount of the third installment or any portion of the fourth installment. Eventually, Kurtin brought a second lawsuit against the debtor for breach of the provision that limited the distributions that he could take from the Entities and obtained a judgment against the debtor and two Entities that had been declared to be his alter egos for $33.89 million. Kurtin recorded abstracts of this judgment.

The debtor and his alter egos then filed chapter 11. Their cases were substantively consolidated and eventually converted to chapter 7. The debtor commenced and the trustee continued to prosecute an adversary proceeding against Kurtin to subordinate his claims and liens under section 510(b), which provides for subordination of claims that arise from the purchase or sale of a security. Kurtin advanced three arguments by way of defense: (1) because the Entities were worth less than the amount of the first settlement payment, the outstanding payments were solely attributable to the claim releases and had nothing to do with the purchase or sale of securities; (2) his judgment arose solely from the post-transfer diversion of assets from the Entities and not from the sale of securities; and (3) section 510(b) only provides for the subordination of claims, and does not permit the subordination of liens. The bankruptcy court and the BAP rejected all three of these arguments.

In the view of the BAP, the plain terms of the agreement established that it involved the purchase and sale of securities – the agreement required Kurtin to transfer his interest in the Entities to the debtor in exchange for settlement payments. Nothing in the agreement suggested that the first settlement payment was intended as the purchase price for the entities, and California law does not permit apportionment of cash consideration when the contract itself does not provide some basis or means for allocating consideration as between the various items or services for which it was given. Therefore, the contract is indivisible and cannot be apportioned, and section 510(b) applies even if some aspects of the agreement do not relate directly to the purchase or sale of securities. To hold otherwise would be to re-write section 510(b) to provide for subordination only when a claim arises **solely** from the purchase or sale of securities, and this is not what the statute says. With regard to Kurtin's second argument, the BAP explained that the purpose of the provision prohibiting diversions from the Entities was to ensure that the Entities would be able to pay Kurtin the consideration he was entitled to receive in exchange for his interests in the Entities. Thus, the claim originated or flowed from his efforts to divest himself of his equity investment and falls within the reach of section 510(b). With regard to Kurtin's last argument, the BAP noted that the subordination of his liens resulted from nothing more than a recognition of the well-established proposition that a lien is an incident of a debt and that, once a claim has been subordinated, the lien automatically follows the debt and is subordinated as well.

18. <u>Smart Cap. Invs. I, LLC v. Hawkeye Ent., LLC (In re Hawkeye Ent., LLC)</u>, 49 F.4th 1232 (9th Cir. 2022) VK

The debtor, Hawkeye Entertainment, LLC, had leased several floors in a commercial building in downtown Los Angeles from Smart Capital Investments. Over time, relations between lessor and lessee became strained and Smart took steps to terminate the lease, claiming that Hawkeye had committed numerous breaches under the lease. Hawkeye filed chapter 11 and sought to assume the lease. The bankruptcy court granted the debtor's motion to assume over the lessor's objections, and the lessor appealed, arguing that the bankruptcy court had erred by not requiring the debtor to provide adequate assurance of future performance.

After a lengthy discovery period, the bankruptcy court conducted a trial on the debtor's motion to assume. During the trial, the bankruptcy court noted on the record that, only two months before the lessor sent its first notice of default, the principal of the lessor had told a prospective lender that it had no knowledge of any uncured defaults by the debtor and that many of the alleged breaches had been ongoing for years and appeared manufactured, minor, and, in some instances, made up. Section 365(b)(1) of the Bankruptcy Code requires a debtor in possession to provide adequate assurance of future performance under a lease when there has been a default. The bankruptcy court had held that, to trigger the adequate assurance requirement, a default must be something that would warrant forfeiture or termination of the lease under California law. In the view of the bankruptcy court, section 365(b)(1) is not triggered by minor, immaterial defaults or previously cured defaults.

The Circuit disagreed with this analysis for two reasons. First, the Circuit noted that the plain language of section 365(b)(1) provides that it is triggered "if there ***has been*** a default," not where there ***is*** a default. Congress's decision to use the past tense of the verb "to be" with the auxiliary verb "has" to describe when adequate assurance is required means that this section refers to situations in which a default has occurred, regardless of whether or not the default has been cured. Although no cure is required if a default has already been cured, the debtor in possession is nevertheless required to provide compensation for any pecuniary loss and adequate assurance of future performance. Second, the Circuit found no support for the bankruptcy court's decision that a default must be "material" to trigger the obligation to provide adequate assurance. There is nothing in the bankruptcy code to support this conclusion. The section refers merely to a default, and this term must be given its ordinary meaning – a failure to perform a task or fulfill an obligation. Neither California law nor the terms of the lease suggested any reason to depart from this definition. However, the Circuit viewed this as harmless error on the part of the bankruptcy court as, on the facts of this case, any required adequate assurance would be little more than simple promises not to deviate from the contract terms again in the future, and the lessor had been unable to identify what more would be needed to address any insecurity that it may have based upon the debtor's alleged lack of performance in the past. Therefore, the Circuit affirmed the bankruptcy court's decision to grant the debtor's motion to assume the lease without requiring any additional assurance of future performance.