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# Bankruptcy

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# BANKRUPTCY

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## I. INTRODUCTION

**A**N increasing amount of activity involving bankruptcy and related commercial law matters occurred during the Survey period. Perhaps the most important development was the ruling by the United States Supreme Court in the *Florida Department of Revenue v. Piccadilly Cafeterias* matter, discussed in Section III.A. *infra*, which announced the correct application to the stamp tax exemption contained in section 1146(a) of the Bankruptcy Code (the Code). The Fifth Circuit and Texas bankruptcy and district courts issued a wide variety of bankruptcy decisions. Many of those decisions, however, were fact-specific or did not otherwise represent a significant development in bankruptcy law. The authors have attempted to assemble a wide variety of cases whose legal holdings will impact bankruptcy practice and which will therefore have significance beyond the particular opinion. Based on their practice and experience, the authors believe that the cases presented should be relevant to the bankruptcy practitioner and worth remembering. Many of these cases are interesting even apart from their legal implications. With the challenging economy and the record number of bankruptcy filings in 2009, the authors anticipate that over the next year there will be substantially more decisions having even broader impact and wider scope.

## II. ADMINISTRATIVE CLAIM/EXECUTORY CONTRACTS

### A. *MEREDITH CORPORATION V. HOME INTERIORS & GIFTS, INC.* (*IN RE HOME INTERIORS & GIFTS, INC.*)

In *In re Home Interiors*, the debtor rejected an executory contract for intellectual property rights but continued to use the rejected marks and

associated rights after the rejection.<sup>1</sup> The court faced the issue of whether the creditor was entitled to an administrative claim even though all conditions necessary for the debtor's use of the marks were completed pre-petition, meaning that there was no post-petition inducement.<sup>2</sup> The court ultimately found: (1) that the creditor was entitled to an administrative claim because of the debtor's post-petition use of the marks, and (2) an over-emphasis on post-petition inducement was misplaced in the trademark licensing scenario.<sup>3</sup> The court also concluded that the measure of the administrative claim would be the contract rate, as the debtor failed to provide sufficient evidence that the contract rate was not the fair market value rate.<sup>4</sup>

The debtor sold home décor products through a network of design consultants who hosted in-home parties.<sup>5</sup> The parties executed a pre-petition, long-term executory license agreement that permitted use of the creditor's trademarks in connection with the debtor's products in exchange for royalties payable to the creditor. The debtor rejected the contract approximately six weeks after the petition date. The creditor thereafter sought the allowance of an administrative expense claim for the debtor's post-petition usage and sale of products bearing the creditor's marks. The creditor never sought relief from the automatic stay to terminate the license agreement. The creditor sought an administrative claim for two periods: (1) the post-petition, but pre-rejection period, and (2) the post-petition, post-rejection period (prior to the next quarterly catalog).<sup>6</sup> The issue before the court was whether the claim in question was simply a contract rejection claim, or if a post-petition component entitled the creditor to an administrative claim.<sup>7</sup>

The court noted that in order for a claim to be entitled to administrative priority under section 503(b) of the Code, the "claim against the estate must have arisen post-petition and as a result of actions taken by the trustee that benefitted the estate."<sup>8</sup> The claim must have arisen from a transaction with the estate, as opposed to one merely with the pre-petition debtor, and, in this respect, "the proper focus [is] on the inducement involved in causing the creditor to part with its goods or services."<sup>9</sup> The court quoted, with approval, a holding from the Sixth Circuit to the effect that "[a] creditor provides consideration to the bankruptcy estate only when the debtor-in possession [sic] induces the creditor's performance. . . . If the inducement came from a pre-petition debtor, then consid-

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1. *Meredith Corp. v. Home Interiors & Gifts, Inc.* (*In re Home Interiors & Gifts, Inc.*), No. 09-31961-11-BJH, 2008 WL 4772102, at \*1-3 (Bankr. N.D. Tex. Oct. 4, 2008).

2. *Id.*

3. *Id.* at \*6-7.

4. *Id.* at \*11-12.

5. *Id.* at \*1.

6. *Id.* at \*3.

7. *Id.* at \*1.

8. *Id.* at \*4 (quoting *In re Jack/Wade Drilling, Inc.*, 258 F.3d 385, 387 (5th Cir. 2001)).

9. *Id.* (quoting *United Trucking Serv., Inc. v. Trailer Rental Co.* (*In re United Trucking Serv., Inc.*), 851 F.2d 159, 162 (6th Cir. 1988)).

eration was given to that entity rather than to the debtor-in-possession."<sup>10</sup>

The goods bearing the creditor's marks were manufactured, marketed, and approved by the creditor pre-petition. However, they were *sold* post-petition, and the proceeds benefited the estate. Accordingly, the court held that the "focus on post-petition 'inducement' is misplaced in a trademark use context," because the debtor used the marks post-petition as a result of the debtor's actions and for the benefit of the estate.<sup>11</sup> Furthermore, "[t]he actual date of product approval or physical production of marketing materials is not the relevant inquiry in the context of the post-petition use of a trademark."<sup>12</sup> Instead, "the true value of a trademark comes from its public use, and in a trademark context, this Court concludes that 'use' can be succinctly defined as a continuous introduction of the mark into the stream of commerce."<sup>13</sup> In essence, the debtor continued to benefit from the use of the marks post-petition and, just as where a debtor uses leased property post-petition, an administrative claim may be awarded without exclusive post-petition inducement.<sup>14</sup>

The court found that, after rejection, the size of the administrative claim is determined by the fair market value of the property or right used by the estate.<sup>15</sup> However, "[a]lthough the contract rate is no longer applicable *per se* in the post-rejection period, courts invariably look to the rates negotiated by the parties in the contract to determine the fair market value of the debtor's continued use of the contracted-for property."<sup>16</sup> Thus, although the appropriate rate is the fair market value rate, "the contract rate is presumed to be the fair rental value" absent evidence by the debtor to the contrary.<sup>17</sup> In this case, the debtor failed to provide sufficient evidence to rebut the presumption that the contract rate was the fair market rate.

### III. ASSET SALES/STAMP TAX EXEMPTION

#### A. *FLORIDA DEPARTMENT OF REVENUE V. PICCADILLY CAFETERIAS, INC.*

In *Piccadilly Cafeterias*, a significant decision that will affect Chapter 11 practice across several circuits, the U.S. Supreme Court definitively addressed the availability of the tax stamp exemption afforded by section

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10. *Id.* at \*5 (quoting *Employee Transfer Corp. v. Grigsby (In re White Motor Corp.)*, 831 F.2d 106, 110 (6th Cir. 1987)).

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.* at \*6.

15. *Id.* at \*11.

16. *Id.*

17. *Id.*

1146(a)<sup>18</sup> of the Code (formerly section 1146(c)).<sup>19</sup> At bar was the issue of whether the operative phrase—“under a plan confirmed”—required the actual confirmation of a plan and the effectuation of the sale through the plan. The Court concluded that the statute means what it says, and the section 1146(a) exemption applies only to a sale actually effectuated under a confirmed plan.<sup>20</sup>

Before *Piccadilly Cafeterias*, the practice in many courts was to invoke the tax stamp exemption with respect to a sale under section 363 of the Code outside a plan, even when there was no plan on file, under the theory that a sale would not be completed until the proceeds were distributed, which would occur through a plan.<sup>21</sup> The *Piccadilly Cafeterias* debtor argued that the exemption should apply even though the sale was effectuated prior to the filing of the plan, because the plan, which enacted various settlements, would determine the distribution of the sale proceeds.<sup>22</sup>

In rejecting this argument, the Court reviewed relevant precedent, considered the purposes of the Code, and applied canons of statutory interpretation to conclude that the section “affords a stamp-tax exemption only to transfers made pursuant to a Chapter 11 plan that has been confirmed.”<sup>23</sup> Of additional interest—and of potential application to other ambiguities under the Code—the Court noted that section 1146 was located in the section of the Code labeled Postconfirmation Matters, thereby further evidencing congressional intent that the sale must be effectuated under the plan itself.<sup>24</sup> Absent action by Congress, the Supreme Court put this issue to rest; but the effect on Texas practice, given Texas’ substantially different bulk sale statutes, may not prove significant.

#### IV. ATTORNEYS/BAPCPA

##### A. *HERSH V. UNITED STATES*

The Fifth Circuit in *Hersh* held that attorneys may qualify as “debt relief agencies” under certain provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).<sup>25</sup> Section 526(a)(4) of the Code, enacted as a result of BAPCPA, prohibits a “debt relief agency” from advising:

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18. The statute provides that “[t]he issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer *under a plan confirmed* under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.” 11 U.S.C. § 1146(a) (2006) (emphasis added).

19. Fla. Dep’t of Revenue v. *Piccadilly Cafeterias, Inc.*, 128 S. Ct. 2326, 2329 (2008).

20. *Id.* at 2339.

21. *Id.* at 2330-31 n.2.

22. *Id.* at 2330-32. The Eleventh Circuit agreed, holding that the “tax exemption may apply to *those* pre-confirmation transfers that are necessary to the consummation of a confirmed plan of reorganization, which, at the very least, requires that there be some nexus between the pre-confirmation transfer and the confirmed plan.” *Id.* at 2331.

23. *Id.* at 2339.

24. *Id.* at 2336.

25. *Hersh v. United States*, 553 F.3d 743, 749 (5th Cir. 2008).

an assisted person or prospective assisted person to incur more debt in contemplation of such person filing a case under this title or to pay an attorney or bankruptcy petition preparer fee or charge for services performed as part of preparing for or representing a debtor in a case under this title.<sup>26</sup>

The circuit court also addressed section 527(b) of the Code,<sup>27</sup> which requires a “debt relief agency” to provide certain information to the prospective debtor.<sup>28</sup> The district court agreed with Hersh’s argument that, by restricting the advice she could give to clients contemplating bankruptcy, section 526(a)(4) of the Code violated First Amendment free speech protections.<sup>29</sup>

The Fifth Circuit applied the plain meaning of the BAPCPA to conclude that attorneys fall within the concept of “debt relief agency” as “any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration.”<sup>30</sup> The circuit court also noted that the legislative history indicates that Congress intended the act to apply to attorneys in order to address what was perceived as potential abuse by some attorneys, in addition to such abuse by debtors.<sup>31</sup> Thus, both the express language of the statute and its legislative history confirm that the definition of “debt relief agency” does include attorneys, if they fall within the definition.<sup>32</sup>

The Fifth Circuit reversed the lower court’s finding of unconstitutionality with respect to section 526(a)(4) of the Code.<sup>33</sup> It noted the availability of the doctrine of constitutional avoidance, or “where an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress.”<sup>34</sup> With respect to section 526(a)(4) of the Code, there were admitted constitutionally valid situations in which Congress could regulate speech without violating the First Amendment, such as in preventing abuse and by protecting honest debtors whose discharge might be denied as a result of a prohibited action.<sup>35</sup> Moreover, if a debtor incurs debt knowing that he either cannot or will not pay, such an action may amount to fraud.<sup>36</sup> In these circumstances, section 526(a)(4) of the Code would pass constitutional muster.<sup>37</sup> However, the question was whether section 526(a)(4) was overbroad, encompassing situations lacking abusive or fraudulent in-

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26. 11 U.S.C. § 526(a)(4) (2006).

27. *Hersh*, 553 F.3d at 749.

28. 11 U.S.C. § 527(b).

29. *Hersh*, 553 F.3d at 749.

30. *Id.* at 750 (quoting 11 U.S.C. § 101(12A)).

31. *Id.* at 751.

32. *Id.* at 750-51.

33. *Id.* at 746.

34. *Id.* at 753-54.

35. *Id.* at 754-55.

36. *Id.* at 755.

37. *Id.* at 755-56.

tent, in which case the regulated speech would be constitutionally protected.<sup>38</sup>

The Fifth Circuit concluded that the doctrine of constitutional avoidance provides a sufficient remedy.<sup>39</sup> Since the statute was not facially unconstitutional, reading the statute as prohibiting speech that the government could prohibit, but not seeking to prohibit speech that was constitutional, meant that the statute passed constitutional muster.<sup>40</sup> It should be noted that the circuit court more than once recognized that: (1) the attorney was not contemplating violating the statute in bad faith; (2) only civil damages against the attorney were available to the client for a violation of the statute; and (3) there was no evidence that the government was enforcing, or was about to enforce, the statute against the attorney or other similarly situated attorneys (or debtors).<sup>41</sup> The circuit court might have applied a more rigid analysis had the statute been enforced through a punitive mechanism, given the harsher potential consequences in that circumstance of an erroneous belief that the statute did not apply.

With respect to the issue regarding section 527(b) of the Code, the court concluded that the government has a “substantially compelling” interest “in ensuring that debtors who are contemplating filing for bankruptcy have some basic knowledge about the process.”<sup>42</sup> The Fifth Circuit court noted that section 527(b) of the Code requires only that the “debt relief agency” must provide some information to the client.<sup>43</sup> This does not mean that the attorney is required to provide “false and misleading” information, as the attorney “is free to explain every detail of the bankruptcy process as it applies to her client [and] may even alter the language of the statement to fit her preferences as long as the content remains substantially similar.”<sup>44</sup>

It is difficult to tell what to make of this opinion; given the potential for *en banc* or further review, the matter may very well be revisited. It is somewhat disconcerting that the government may prohibit an attorney from providing certain otherwise lawful advice to a debtor and that it may require the attorney to make (or not make) certain statements to the debtor. On the other hand, the Fifth Circuit narrowly construed the prohibition to situations where most would likely agree that it would be inappropriate to incur new debt on the eve of a filing. Moreover, the information required to be provided by section 527(b) of the Code is just information, of an apparently harmless nature, designed to address the

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38. *Id.* at 756. For example, it may well be in the interest of everyone involved in the situation, and therefore not abusive or wrongful, for a particular debtor to refinance his homestead at a lower rate on the eve of bankruptcy. *Id.* at 753. Section 526(a)(4) of the Code would limit the advice that could be given to this debtor despite the legitimate and helpful purpose of that advice. See 11 U.S.C. § 526(a)(4) (2006).

39. *Hersh*, 553 F.3d at 756.

40. *Id.*

41. *Id.* at 748.

42. *Id.* at 766.

43. *Id.* at 767-68 (internal quotations omitted).

44. *Id.* at 767.



problem among certain debtor lawyers who are perceived as being unresponsive to the client. The potential concern with *Hersh* is therefore not necessarily the facts before it, but rather the potential for a slippery slope with the government dictating more in the future about what advice can or cannot be given to a client in contemplation of a bankruptcy filing.

### B. *IN RE HENDERSON*

At first blush, the issue in *In re Henderson*—whether the death of the debtor excuses the completion of a financial management course required to obtain a discharge<sup>45</sup>—may seem ridiculous and the result obvious. However, the death of a debtor during a case is specifically addressed in the Bankruptcy Rules,<sup>46</sup> and there may be good reasons for exemptions and the discharge of debt notwithstanding the death. BAPCPA requires that a debtor complete a financial management course and that the failure to do so may be grounds for the denial of discharge.<sup>47</sup> But what if the debtor dies before completing one?

The court did not struggle to reach the conclusion that the debtor's death legitimately excused literal compliance with the financial management requirement.<sup>48</sup> As held by the *In re Henderson* court,

[i]f the debtor is “disabled” within the meaning of section 109(h)(4), then the debtor is excused from the requirement . . . [t]he statutory language (added in 2005) seems not to have anticipated the possibility that debtor might die after filing but before completing the mandated instructional course. Still, the intent of Congress seems obvious at least from its context, if not from its express wording.<sup>49</sup>

Although the importance of this opinion appears to be limited to its facts, it may be of significance in those cases where the debtor dies during the pendency of a case and prior to fulfilling one of a host of bankruptcy requirements.

### C. *CAPLIN & DRYSDALE CHARTERED v. BABCOCK & WILCOX CO.* (*IN RE BABCOCK & WILCOX CO.*)

The Fifth Circuit in *In re Babcock & Wilcox* concluded that the bankruptcy court did not abuse its discretion by awarding non-working travel time at fifty percent of the hourly rate.<sup>50</sup> The bankruptcy court previously approved the employment of the law firm as counsel for the asbestos claimants' committee, meaning that the firm was to be paid and reimbursed for expenses from the estate, subject to allowance under sec-

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45. *In re Henderson*, No. 06-52439-C, 2008 WL 1740529, at \*1 (Bankr. W.D. Tex. 2008).

46. See FED. R. BANKR. P. 1016.

47. See 11 U.S.C. § 727(a)(11) (2006).

48. *In re Henderson*, 2008 WL 1740529, at \*1.

49. *Id.*

50. *Caplin & Drysdale Chartered v. Babcock & Wilcox Co.* (*In re Babcock & Wilcox Co.*), 526 F.3d 824, 826 (5th Cir. 2008) (per curiam).

tion 330 of the Code.<sup>51</sup> The firm requested the allowance of fees for the travel time of its attorneys at the full hourly rate of the attorneys.<sup>52</sup> The United States Trustee objected, and the bankruptcy court ultimately awarded attorney's fees at fifty percent of the full hourly rate for non-working travel time.<sup>53</sup>

The Fifth Circuit noted that a bankruptcy court's award of attorney's fees is reviewed for abuse of discretion and that "[a] bankruptcy court abuses its discretion when it: (1) applies an improper legal standard or follows improper procedures in calculating the fee award; or (2) rests its decision on findings of fact that are clearly erroneous."<sup>54</sup> The circuit court also acknowledged that the claimant bears the burden of proving the reasonableness of compensation under section 330 of the Code.<sup>55</sup> At the same time, however, the Fifth Circuit recognized the principles embodied in the Code that estate professionals should be compensated the same in bankruptcy as they would outside of bankruptcy in order to retain the most capable counsel.<sup>56</sup>

In affirming the bankruptcy court's decision, the Fifth Circuit determined that "there is not a consensus regarding the billing of travel time under [section] 330."<sup>57</sup> In analogous situations, non-working travel time had been awarded at fifty percent while certain bankruptcy courts had awarded such time at one hundred percent.<sup>58</sup> With respect to the law firm's evidentiary burden, the circuit court agreed that the firm failed to present a sufficient factual showing of the firm's billing practice related to comparable firms.<sup>59</sup> Accordingly, the bankruptcy court did not abuse its discretion.<sup>60</sup>

In the end, because the circuit court only held that the bankruptcy court did not abuse its discretion, *In re Babcock & Wilcox* is neither remarkable nor likely to change regular practice.<sup>61</sup> The holding is not that non-working travel time *must be paid* at fifty percent of standard rate, or that it cannot be paid at one hundred percent. This would have been the issue had the law firm made the required evidentiary showing regarding customary and ordinary billing practices for New York City attorneys. Therefore, this ultimate question must await a future ruling.<sup>62</sup> It seems

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51. *Id.* at 826-27.

52. *Id.* at 826.

53. *Id.*

54. *Id.* (quoting *In re Cahill*, 428 F.3d 536, 539 (5th Cir. 2005)) (internal quotations omitted).

55. *Id.* at 827.

56. *See id.*

57. *Id.* at 828.

58. *See id.*

59. *Id.* at 827.

60. *Id.* at 826, 829.

61. In the United States Bankruptcy Court for the Northern District of Texas, for example, local standing orders provide that non-working travel time is usually payable at fifty percent of the full hourly rate. BANKR. N.D. TEX. GEN. ORDER 2006-02, GUIDELINES FOR COMP. & EXPENSE REIMBURSEMENT OF PROF'LS ¶ II.G. (2006).

62. *See Babcock & Wilcox Co.*, 526 F.3d at 828-29.

unlikely that the Fifth Circuit will issue a *per se* holding that non-working travel time must be compensated at a specific rate, for multiple reasons, including the discretion allowed the bankruptcy courts to interpret the facts at hand, the language of section 330 of the Code, and the potential for abuse.

D. *KAYE V. HUGHES & LUCE, LLP (IN RE GADZOOKS INC.)*

This important case is analyzed in this article so that professionals will remain apprised of recent developments. *In re Gadzooks Inc.* examines the issue of whether the allowance of attorney's fees and the reimbursement of expenses under section 330 of the Code is subject to a "material benefits" test that weighs the benefits of attorney services in hindsight.<sup>63</sup> Hughes & Luce served as counsel for the equity committee at a time when the bankruptcy case appeared to be one in which the equity interest holders would receive a distribution. Ultimately, the equity interests holders did not receive any distribution, and the question, therefore, was whether the services of Hughes & Luce provided a benefit to the estate.<sup>64</sup>

The bankruptcy court applied a "reasonable benefit" test and allowed fees because, at the time that the fees were provided, they appeared reasonably likely to provide a benefit.<sup>65</sup> On the other hand, the district court applied a "material benefits" test and reviewed the benefit of the fees in hindsight.<sup>66</sup> This ruling caused quite a stir given its potentially chilling effect on the provision of professional fees and expenses if they were to be judged with the benefit of hindsight, especially in the many bankruptcy cases that ultimately succeed even though, at times, success appears in question.<sup>67</sup>

The Fifth Circuit dismissed the appeal because the district court's order was not a final decision.<sup>68</sup> The district court, in reversing the bankruptcy court's legal application, remanded the case to the bankruptcy court for further findings in light of the district court's standard. Because the bankruptcy court was to perform a judicial, as opposed to a ministerial function, the district court order was not "final," and the Fifth Circuit lacked appellate jurisdiction.<sup>69</sup> This decision will prolong the debate over the appropriate standard of review of fee applications and continue the present uncertainty occasioned by the district court's opinion.

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63. *Kaye v. Hughes & Luce, LLP (In re Gadzooks, Inc.)*, 291 F. App'x 652, 653 (5th Cir. 2008).

64. *Kaye v. Hughes & Luce, LLP*, No. 3:06-CV-01863-B, 2007 WL 2059724, at \*1-2 (N.D. Tex. July 13, 2007).

65. *Id.* at \*2.

66. *In re Gadzooks*, 291 F. App'x at 653.

67. *See Kaye*, 2007 WL 2059724, at \*12.

68. *In re Gadzooks*, 291 F. App'x at 653.

69. *Id.* at 653-54.

## V. AUTOMATIC STAY

A. *CAMPBELL v. COUNTRYWIDE HOME LOANS, INC.*

*Campbell* addresses the issue of whether the filing of a proof of claim in a bankruptcy case to increase the amount of post-petition escrow payments violates the automatic stay.<sup>70</sup> Not surprisingly, the Fifth Circuit held that the mere filing of a proof of claim in the bankruptcy case does not violate the automatic stay.<sup>71</sup> In a broader sense, the Fifth Circuit endorsed the notion, without specifically so holding, that actions, documents, and proceedings commenced or undertaken in the bankruptcy case cannot violate the automatic stay.<sup>72</sup>

The Chapter 13 debtors sought damages from their home mortgage lender, Countrywide, arguing that Countrywide violated the automatic stay by the wording of its proof of claim filed in their bankruptcy case. Specifically, Countrywide included language that the post-petition monthly amount for the mortgage would increase by almost \$100 post-petition on account of monthly escrow payments.<sup>73</sup> The debtors objected to this portion of the proof of claim, the bankruptcy court allowed the claim, but disallowed the increased post-petition amounts, and ultimately the bankruptcy court confirmed a plan providing for mortgage payments in the amount of the debtors' pre-petition payments. The debtors also sought damages for a stay violation, arguing that the filing of this proof of claim (or including the objectionable language) was an attempt to collect a pre-petition claim. The bankruptcy court agreed that Countrywide's actions amounted to a willful violation of the automatic stay.<sup>74</sup>

On interlocutory appeal, the Fifth Circuit reversed, agreeing with the bankruptcy court that, based on the Code's definition of "claim," Countrywide attempted to collect a pre-petition claim by filing the proof of claim. However, the circuit court disagreed that the filing of a proof of claim could constitute a violation of the automatic stay. It noted that certain categories of judicial filings and actions are specifically stayed under section 362(a) of the Code.<sup>75</sup> But, the Code also specifically provides for the right to file a proof of claim in section 501, and section 501 is not among the judicial activities specifically enumerated in section 362(a). The circuit court stated:

We find no precedents in which a court has held that asserting a right to payment in a Proof of Claim constitutes a violation of the automatic stay. In fact, a number of courts . . . have found that an automatic stay has no effect on actions that are expressly allowed under the Bankruptcy Code.<sup>76</sup>

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70. *Campbell v. Countrywide Home Loans, Inc.*, 545 F.3d 348, 350 (5th Cir. 2008).

71. *Id.* at 356-57.

72. *Id.* at 355-56.

73. *Id.* at 351.

74. *Id.* at 353-54.

75. *Id.* at 355-56.

76. *Id.* at 356.

If a creditor files an incorrect or even absurd proof of claim, the Code contains a remedy and an appropriate mechanism: an objection to the claim.<sup>77</sup> This is exactly what happened in this case. Although the immediate factual situation of this case appears narrow, it puts to rest the argument that relief from the automatic stay is necessary before a proceeding or action is commenced *in the bankruptcy court* that would violate the automatic stay if commenced in a different court.<sup>78</sup>

### B. *REPINE V. REPINE (IN RE REPINE)*

The Fifth Circuit in *In re Repine* held that an award of punitive damages for a violation of the automatic stay under section 362(k) requires egregious conduct on the part of the violator.<sup>79</sup>

Young, an attorney, represented the debtor's ex-wife in a child support enforcement action. Pre-petition, the debtor was incarcerated for his failure to pay child support. Young was awarded attorney's fees in the action. The ex-wife filed a child support lien against the debtor's property on the first day of his incarceration. During his incarceration, the debtor filed Chapter 13 bankruptcy.<sup>80</sup> His bankruptcy counsel soon thereafter notified Young of the filing.

The debtor and his ex-wife ultimately resolved their child support issue, and the bankruptcy court entered an order modifying the automatic stay to implement that settlement.<sup>81</sup> The family court denied the settlement based on Young's argument that it did not guarantee that she would be paid her fees under it and that the debtor should remain in prison until he paid the child support.<sup>82</sup> Young thereafter refused to agree to the debtor's release from prison even upon the death of the debtor's father.<sup>83</sup>

The debtor later filed an adversary proceeding in the bankruptcy court against Young. That court found that Young willfully violated the automatic stay, and it awarded actual damages against Young for lost wages, emotional distress, and attorney's fees, as well as \$5,000 in punitive damages.<sup>84</sup> The district court affirmed.<sup>85</sup> The Fifth Circuit considered several issues, including whether Young violated the automatic stay, and found that she had done so by attempting to collect her pre-petition claim for attorney's fees.<sup>86</sup>

The issue of first impression for the Fifth Circuit, however, was the requisite conduct necessary to support an award for punitive damages for an automatic stay violation. It noted that the relevant statute provides

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77. *See id.*

78. *See id.* at 356-57.

79. *Repine v. Repine (In re Repine)*, 536 F.3d 512, 521 (5th Cir. 2008).

80. *Id.* at 515.

81. *Id.* at 516.

82. *Id.* at 516-17.

83. *Id.* at 517.

84. *Id.* at 517-18.

85. *Id.* at 518.

86. *Id.* at 518-20.

that the court may award punitive damages in “appropriate circumstances.”<sup>87</sup> Without detailed analysis, the Fifth Circuit adopted the “egregious conduct” standard: only conduct that is egregious will give rise to punitive damages for an automatic stay violation under section 362(k).<sup>88</sup> In agreeing that Young’s actions rose to this level, the circuit court affirmed the award of punitive damages against her:

Young ignored . . . warnings that efforts to collect her fees would violate the automatic stay, ignored [the debtor’s ex-wife’s] wishes that Repine be released from jail, failed to appear before the Bankruptcy Court despite being ordered to do so, and persisted in her efforts to collect her fees despite the Bankruptcy Court’s admonishment that she cease all collection efforts. This conduct was egregious.<sup>89</sup>

*In re Repine* provides important clarity to Texas courts with respect to the legal standard necessary to impose punitive damages for a stay violation. At the same time, however, the “egregious conduct” standard is somewhat vague and fact-specific. The decision fails to address the appropriateness of punitive damages for a stay violation under anything other than section 362(k) of the Code, such as under section 105(a) of the Code. The circuit court also failed to clarify the requisite level of conduct needed for the imposition of punitive damages under such other provisions, although it is likely and logical that the “egregious conduct” standard would apply (if punitive damages are available under such other provisions).

### C. *IN RE MD PROMENADE, INC.*

The bankruptcy court in *In re MD Promenade, Inc.*, examined a creditor’s standing to assert a cause of action for violation of the automatic stay.<sup>90</sup> Before the petition date, the debtor agreed to vacate certain leased premises in the course of state court litigation. Post-petition, the debtor’s principals and a secured creditor removed property from the leased premises in a highly destructive manner. The lease was subsequently rejected, but no relief from the automatic stay was granted.<sup>91</sup>

The landlord subsequently moved for damages for the violation of the automatic stay and for contempt. The U.S. Bankruptcy Court for the Northern District of Texas found that the debtor’s principals and others willfully violated the automatic stay by exercising control over property of the estate.<sup>92</sup> However, certain of the property removed from the premises belonged to the landlord under the lease, the stay was willfully and intentionally violated only with respect to the property which be-

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87. *Id.* at 521 (quoting 11 U.S.C. § 362(k) (2006)).

88. *Id.*

89. *Id.*

90. *In re MD Promenade, Inc.*, No. 08-34113-SGJ-7, 2009 WL 80203, at \*6-7 (Bankr. N.D. Tex. Jan. 8, 2009).

91. *Id.* at \*1.

92. *Id.* at \*6-7.

longed to the estate.<sup>93</sup>

In determining whether the landlord had standing to seek damages for the stay violation, the court recognized that the secured creditor and the debtor were both controlled by, or related to, the debtor's principals, who, having violated the automatic stay, would have no motivation to seek redress for the stay violation.<sup>94</sup> Such facts were not a prerequisite to seek redress for a stay violation, but the court noted that such factors were part of the reason individual creditors had been found to have standing and why section 363(k) of the Code spoke in broad terms (employing the phrase "individual," as opposed to "debtor" or "trustee").<sup>95</sup>

The court pointed out that "[t]he Fifth Circuit described one of the beneficial effects of the automatic stay is that it halts the traditional 'race to the courthouse' by creditors seeking to collect on debts."<sup>96</sup> The court cited several opinions for the proposition that individual creditors had standing under section 362(h) of the Code (now section 362(k)).<sup>97</sup> However, because the creditor in *In re MD Promenade, Inc.* was not an "individual," as is required by section 362(k) of the Code, that statutory provision was unavailable for the requested damages. Instead, the court held that damages for the stay violation were available under section 105(a) of the Code and pursuant to the court's powers to remedy contempt.<sup>98</sup> As explained by the court, "[s]uch an action does not merely assert a third party's rights or a generalized grievance but, rather, seeks to punish an act which does violence to the essential fabric of the Bankruptcy Code, and which has resulted in particularized harm to the complaining creditor."<sup>99</sup> The court accordingly awarded the trustee, for the estate, contempt damages in the amount of \$250,000.<sup>100</sup>

## VI. CHAPTER 11 PLANS

### A. *ELIXIR INDUSTRIES INC. v. CITY BANK & TRUST CO.* (*IN RE AHERN ENTERPRISES INC.*)

Elixir, a judgment creditor with a judgment lien against real property, filed a proof of claim in the Chapter 11 bankruptcy case and failed to object to the confirmation of the plan.<sup>101</sup> The plan referenced the prop-

93. *Id.*

94. *Id.* at \*1, \*11.

95. *See id.* at \*11-12.

96. *Id.* at \*10 (quoting *GATX Aircraft Corp. v. M/V Courtney Leigh*, 768 F.2d 711, 716 (5th Cir. 1985)). The automatic stay protects the Code's policy of the equality of creditors, and creditors have standing to ensure that this protection is enforced.

97. *Id.* (citing *In re Int'l Forex of Cal., Inc.*, 247 B.R. 284, 290-91 (Bankr. S.D. Cal. 2000); *In re Bequette*, 184 B.R. 327, 332 (Bankr. S.D. Ill. 1995)).

98. *Id.* at \*12.

99. *Id.* at \*11 (quoting *Barnett Bank of S.E. Ga., N.A. v. Trust Co. Bank of S.E. Ga., N.A. (In re Ring)*, 178 B.R. 570, 577 (Bankr. S.D. Ga. 1995)).

100. *Id.* at \*16. Sanctions were awarded to the estate instead of directly to the complaining creditor since it was the estate that was injured by the stay violation.

101. *Elixir Indus. Inc. v. City Bank & Trust Co. (In re Ahern Enters. Inc.)*, 507 F.3d 817, 818-19 (5th Cir. 2007).

erty subject to the lien and preserved a senior secured lender's lien against the property, but failed to mention the judgment creditor's lien. The case was converted to Chapter 7 after the plan's confirmation.<sup>102</sup> The Fifth Circuit examined whether the confirmation of the plan under these circumstances transferred the subject property "free and clear" and voided the judgment creditor's lien; the court held that the confirmation of the plan did indeed void the judgment lien.<sup>103</sup>

The circuit court stated,

[f]our conditions must . . . be met for a lien to be voided under section 1141(c): (1) the plan must be confirmed; (2) the property that is subject to the lien must be dealt with by the plan; (3) the lien holder must participate in the reorganization; and (4) the plan must not preserve the lien.<sup>104</sup>

The judgment creditor in this case filed a proof of claim and participated in the bankruptcy case, but failed to object to the confirmation of the plan. The Fifth Circuit found that the filing of the proof of claim by the judgment creditor constituted sufficient participation in the bankruptcy case.<sup>105</sup>

The plan itself dealt with the subject property, providing that the senior secured lender would retain its lien against the property.<sup>106</sup> In this respect, the Fifth Circuit rejected the argument that the voided lien must itself be dealt with in the plan, it being sufficient that the property, and not the lien, is treated in the plan.<sup>107</sup> The circuit court held that unless the plan explicitly provides for the preservation of the lien, the transfer is free and clear of the lien under section 1141(c) of the Code regardless of the use of the "free and clear" language.<sup>108</sup>

The final and perhaps most important argument addressed by the circuit court was whether the confirmed plan needed to be substantially consummated prior to the avoidance of the judgment lien. It held: "we conclude that regardless of how the term 'consummation' is interpreted . . . Elixir's lien was voided *upon confirmation of the plan*."<sup>109</sup> It therefore did not matter that the plan did not reach "substantial consummation" or that the case was converted to Chapter 7 shortly after the confirmation of the plan:

The language of section 1141(c) similarly provides that the property dealt with by the plan . . . is free and clear *after confirmation*. Even if Elixir's interpretation of the plan is correct, and the plan did not take

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102. *Id.* at 819.

103. *Id.* at 818, 824-25.

104. *Id.* at 822.

105. *Id.* at 823.

106. *Id.* at 824. The plan therefore mentioned the subject property and addressed the preservation of another creditor's lien against the property.

107. *Id.* at 823 ("[A] requirement that the lien itself be dealt with by the plan is not a sensible reading of section 1141(c).").

108. *Id.* at 823-24.

109. *Id.* at 825 (emphasis added).



effect until the Consummation Date, its lien was void after confirmation of the plan, by operation of § 1141(c), unless the plan specifically provides otherwise.<sup>110</sup>

## VII. CORE/NON-CORE PROCEEDINGS

### A. *BEITEL v. OCA, INC. (IN RE OCA, INC.)*

The Fifth Circuit has frequently analyzed the legal standard applying to a “core proceeding.” In most non-core proceedings, a defendant may consent to the bankruptcy court’s entry of final orders under 28 U.S.C. § 157(c)(2), which the Fifth Circuit refers to as the bankruptcy court exercising full adjudicatory powers. The defendant in *In re OCA, Inc.* was sued in an adversary proceeding but failed to file an answer after being properly served and received a default judgment.<sup>111</sup> The issue before the Fifth Circuit, which held that the proceeding against the defendant was non-core,<sup>112</sup> was whether the bankruptcy court could enter a final default judgment notwithstanding the non-core nature of the proceeding.<sup>113</sup>

The circuit court concluded that the bankruptcy court could indeed issue the final default judgment based on the defendant’s “implied[ ] consent[ ] to the bankruptcy court’s entry of final orders and judgments.”<sup>114</sup> It recognized that the consent to the bankruptcy court’s entry of final orders in non-core proceedings “may be express or implied”<sup>115</sup> and that the “[f]ailure to object in the bankruptcy court may constitute implied consent.”<sup>116</sup> Here, the defendant could have objected to the bankruptcy court’s exercise of core jurisdiction by answering the complaint. Moreover, the defendant admitted in a motion to set aside the default judgment that the proceeding was “core.”<sup>117</sup> The circuit court observed that the defendant’s action “more closely resembles an afterthought than a bona fide objection.”<sup>118</sup>

Accordingly, the Fifth Circuit concluded that the defendant had failed to timely object to the exercise of core jurisdiction and that his post-default judgment admission that the jurisdiction was core sufficed, notwithstanding his subsequent arguments to the contrary.<sup>119</sup> Unlike subject matter jurisdiction, the core/non-core issue could be and was waived. Default judgment by the bankruptcy court was therefore appropriate<sup>120</sup> even

110. *Id.*

111. *Beitel v. OCA, Inc. (In re OCA, Inc.)*, 551 F.3d 359, 364-65 (5th Cir. 2008).

112. *Id.* at 368.

113. *See id.* at 367.

114. *Id.* at 368.

115. *Id.* (citing *M.A. Baheth & Co. v. Schott (In re M.A. Baheth Constr. Co.)*, 118 F.3d 1082, 1084 (5th Cir. 1997)).

116. *Id.* (citing *McFarland v. Leyh (In re Tex. Gen. Petrol. Corp.)*, 52 F.3d 1330, 1337 (5th Cir. 1995)).

117. *Id.*

118. *Id.* at 369 (internal quotation omitted).

119. *Id.* at 368.

120. Default judgment, however, was found inappropriate on other grounds. *See id.* at 374.

though the proceeding was non-core.<sup>121</sup>

## VIII. CREDITORS MEETING

### A. *PERES v. SHERMAN (IN RE PERES)*

The conclusion of the meeting of creditors is important for several deadlines under the Code and the Bankruptcy Rules, particularly in consumer bankruptcy cases. In *In re Peres*, the meeting of creditors was continued three times.<sup>122</sup> At the time of the final continuance, the Chapter 7 trustee did not announce a date for its continuance.<sup>123</sup> The meeting was subsequently rescheduled, and then continued again. The debtors argued that the trustee's later objections to exemptions were untimely, since the third continuation of the meeting of creditors, with no formal notice of its continuation date, meant that the meeting of creditors concluded as of that date.<sup>124</sup>

The Fifth Circuit rejected this argument and two "bright-line" approaches, holding that if a trustee does not announce a specific date to which the meeting is being continued within thirty days of the last meeting held, the meeting will be deemed to have been concluded on the "last date it was convened."<sup>125</sup> The circuit court also rejected an alternative bright-line rule, disagreeing that "a meeting of creditors is not concluded until such time as the trustee so declares or the court so orders."<sup>126</sup> Such an approach conflicts with the Code's strong policy of promptness, and either rule could impede the interests of justice in complex cases or in cases requiring additional review and discovery.<sup>127</sup>

The circuit court instead adopted a case-by-case approach, applying "at least four factors in determining the reasonableness of a trustee's delay in adjourning a meeting of creditors: (1) the length of the delay; (2) the complexity of the estate; (3) the cooperativeness of the debtor; and (4) the existence of any ambiguity regarding whether the trustee continued or concluded the meeting."<sup>128</sup> In *In re Peres*, the trustee acted reasonably in continuing the meeting of creditors several times.<sup>129</sup> Additionally, the circuit concluded that the continuation of the meeting did not require written notice, unlike the date of the initial meeting.<sup>130</sup> Given these considerations, and the fact that there was no ambiguity concerning the adjournment of the meeting as opposed to its conclusion (the transcript

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121. *Id.*

122. *In re Peres*, 530 F.3d 375, 376 (5th Cir. 2008).

123. *Id.*

124. *Id.*

125. *Id.* at 377.

126. *Id.* at 378.

127. *See id.*

128. *Id.*

129. The court granted the continuances for various reasons, including to give debtors an opportunity to gather records and because of an unprecedented amount of BAPCPA-related Chapter 7 filings in the court system at that time.

130. *Id.* at 378-79.

clearly revealed that the meeting was “continued”), the trustee properly *continued* the meeting of creditors and did not, in the process, *conclude* the meeting.

## IX. DEFAULT JUDGMENTS

### A. *BEITEL v. OCA INC. (IN RE OCA, INC.)*

The Fifth Circuit in *In re OCA, Inc.*, decided that there is no presumption that a failure to answer a complaint is willful and that the “preponderance of the evidence,” rather than the “clear and convincing,” standard applies in the analysis.<sup>131</sup> The bankruptcy court had issued a default judgment. On appeal from the denial of a motion for new trial, the circuit court articulated the factors for setting aside a default judgment:

whether the default was willful, whether setting it aside would prejudice the adversary, and whether a meritorious defense is presented. Courts may also consider whether the public interest was implicated, whether there was significant financial loss to the defendant, and whether the defendant acted expeditiously to correct the default. The district court need not consider all of the above factors in ruling on a defendant’s 60(b)(1) motion.<sup>132</sup>

The Fifth Circuit agreed that there was a presumption of valid service by mail and that clear and convincing evidence is required for a finding that proper mail service had not in fact been accomplished.<sup>133</sup> However, the circuit court expressed concern that the bankruptcy court appeared to apply such a presumption to the issue of willfulness as well.<sup>134</sup>

The Fifth Circuit rejected both this presumption and the application of the clear and convincing standard. “If courts were to require clear and convincing evidence to overcome a putative willfulness presumption, the instruction to apply Rule 60(b) ‘most liberally’ when considering whether to vacate a default judgment would be rendered meaningless.”<sup>135</sup> Accordingly, “trial courts must apply only the preponderance-of-the-evidence standard when assessing willfulness.”<sup>136</sup>

## X. DEEPENING INSOLVENCY

### A. *WOOLEY v. FAULKNER (IN RE SI RESTRUCTURING, INC.)*

The Fifth Circuit in *In re SI Restructuring, Inc.* examined the second element of equitable subordination, which requires harm to creditors.<sup>137</sup> The unsecured creditors’ committee in this case denied that it based its

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131. *Beitel v. OCA, Inc. (In re OCA, Inc.)*, 551 F.3d 359, 372 (5th Cir. 2008).

132. *Id.* at 369.

133. *See id.* at 371.

134. *See id.* at 371-73.

135. *Id.* at 372.

136. *Id.*

137. *See Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355, 357 (5th Cir. 2008).

argument for harm to creditors on a “deepening insolvency” theory, but its expert acknowledged that he used such a theory to calculate damages.<sup>138</sup> The expert calculated that the debtor lost \$3.5 million between the time it made the loans in question and the petition date. He argued that the loans caused the lost value because, absent the loans, the debtor would have been forced to file bankruptcy sooner and there would have been more value for distribution.<sup>139</sup> The circuit court defined the theory of deepening insolvency as “prolonging an insolvent corporation’s life through bad debt, causing the dissipation of corporate assets.”<sup>140</sup> In *dicta*, the Fifth Circuit firmly rejected the deepening insolvency theory.<sup>141</sup>

Quoting the Delaware Court of Chancery, a leading authority on issues of corporate management and liability, the circuit court stated:

Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm’s operations in the hope that they can expand the inadequate pie such that the firm’s creditors get a greater recovery. By doing so, the directors do not become a guarantor of success.<sup>142</sup>

Given that the circuit court failed to rule directly on the issue, *In re SI Restructuring, Inc.* does not fully settle the viability of the theory of deepening insolvency. However, the circuit court’s comment that it has “little legal support” indicates that future litigants will have a difficult time convincing a bankruptcy court that the Fifth Circuit would not reject the theory. Perhaps a set of egregious facts could convince a court otherwise, but then it is likely that such egregious facts would support different and more traditional and accepted theories of liability or damages.

## XI. EXEMPTIONS

### A. *SOZA V. HILL (IN RE SOZA)*

The day before they filed a voluntary Chapter 7 petition, the debtors in *In re Soza* purchased a \$30,000 annuity with non-exempt assets and listed the annuity as exempt property pursuant to the Texas exemption statutes.<sup>143</sup> The bankruptcy court sustained the objection to exemptions

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138. *Id.* at 362-63.

139. *See id.* at 363.

140. *Id.*

141. *Id.* The Fifth Circuit found that the application of a deepening insolvency theory was not warranted by the factual record, and it specifically noted that it did not consider the legal viability of the deepening insolvency theory. *Id.* at 364. Although its comments regarding the legal viability of the theory are therefore *dicta*, the strength of those comments, and the very need for them in the opinion (or rather lack of such a need), are telling as to the Fifth Circuit’s ultimate view on this important issue.

142. *Id.* at 363-64 (quoting *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174 (Del. Ch. 2006) (rejecting deepening insolvency as theory of liability or damages)).

143. *Soza v. Hill (In re Soza)*, 542 F.3d 1060, 1063 (5th Cir. 2008).

made by the trustee, but the district court reversed. The district court disagreed with the bankruptcy court's conclusion that constructive fraud sufficed to defeat the exemption, holding instead that actual fraud was required.<sup>144</sup>

The Fifth Circuit reversed the district court's conclusion and stated that actual fraud was not required to defeat the exemption.<sup>145</sup> The operative statutory language requires that the annuity purchase be made "in fraud of a creditor" to except the annuity from the exemption.<sup>146</sup> The circuit court found it significant that the Texas statute did not mention intent and interpreted its omission to mean that something less than actual intent would suffice.<sup>147</sup> It concluded that it was likely that the Texas Supreme Court would hold that actual intent to defraud was unnecessary in order to deny the exemption.<sup>148</sup>

The circuit court observed that "Texas courts will have to determine how much less than actual intent to defraud suffices to deny exemptions for insurance policies and annuities under § 1108.053,"<sup>149</sup> and offered that the "badges of fraud" factors governing fraudulent transfers and other frauds might guide the inquiry.<sup>150</sup> The Fifth Circuit found several of these factors present in *In re Soza*, and concluded that the exemption was properly denied as being in fraud of creditors.<sup>151</sup>

#### B. WALLACE V. ROGERS (*IN RE ROGERS*)

The debtor inherited a 72-acre tract of real property in 1994.<sup>152</sup> The debtor later married and occupied separate real property with her husband as their homestead. Thereafter, and within the 1,215-day period under section 522(p)(1) of the Code, the debtor divorced her husband and moved back to the inherited land, living on it as her homestead. The debtor filed a Chapter 7 case and claimed the inherited land as her homestead with a value of \$359,000.<sup>153</sup> A judgment creditor objected to the exemption, claiming that the debtor acquired her homestead interest within 1,215 days of the petition date and that, accordingly, she could only exempt \$125,000 of the land's value.<sup>154</sup>

In this matter of first impression, the Fifth Circuit affirmed both lower courts and overruled the judgment creditor's objection to exemption, finding the section 522(p)(1) cap with respect to an "interest that was acquired by the debtor during the 1,215-day period preceding the date of

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144. *Id.* at 1064.

145. *Id.* at 1065-66, 1069.

146. *Id.* at 1065 (quoting TEX. INS. CODE ANN. § 1108.053(1) (Vernon 2007)).

147. *Id.* at 1066.

148. *See id.*

149. *Id.*

150. *Id.*

151. *Id.* at 1067.

152. *Wallace v. Rogers (In re Rogers)*, 513 F.3d 212, 216 (5th Cir. 2008).

153. *Id.*

154. *Id.*

the filing of the petition”<sup>155</sup> did not apply.<sup>156</sup> The circuit court examined whether the “interest” at issue must be the homestead interest itself or whether it excludes an ownership interest. In other words, does the cap apply if the debtor owned the property prior to the look-back period but only began using the property during the look-back period, such that the homestead interest, as separate from the ownership interest, was acquired during the look-back period?

The circuit court observed that “[a] homestead interest is not the equivalent of title or equity.”<sup>157</sup> Additionally, the debtor did not increase her equity in the property during the look-back period by paying down debt on the property, and she made improvements by using her exempt retirement funds in an amount less than the section 522(p)(1) amount. Although the property may have appreciated in value during the look-back period, passive equity appreciation is not the acquisition of an interest within the meaning of the statute.<sup>158</sup>

Discussing the crux of the issue, the Fifth Circuit stated that the creditor sought to expand the common view of an “interest” to include a “homestead interest” instead of the more restrictive notion of a “property interest”:

Under Texas law, the homestead interest is a legal interest created by the constitution that . . . gives protective legal security rather than vested economic rights. Although the Texas Supreme Court referred to the homestead interest as a “legal interest” in *Heggen*, we must look beyond that label and consider the substance of the right conferred by state law. Based on our review of the statutory language, we conclude that the term “interest” as used in § 522(p)(1) refers to vested economic interests that the debtor acquires in the homestead property during the 1,215-day period preceding the filing of the petition. Thus, a homestead interest established within the statutory period, without more, does not fall within the purview of § 522(p)(1).<sup>159</sup>

The homestead interest was therefore a legal interest but not a vested economic interest that is applicable to a 522(p)(1) inquiry. For cap purposes, the underlying economic interest must be acquired during the look-back period. In *In re Rogers*, where the debtor did not make large improvements or pay down liabilities against the property (although those factors would not necessarily alter the holding), the fact that the debtor acquired the economic interest in the property outside the look-

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155. 11 U.S.C. § 522(p)(1) (2006).

156. *Rogers*, 513 F.3d at 227.

157. *Id.* at 222.

158. *See id.* Moreover, the divorce decree divested the husband of his interest in the property. While there is some support for the proposition that an interest of a spouse may be “acquired” through a divorce decree that divests the other spouse of a community interest in the property, the property in this case was inherited and never became community property. *See id.* at 222-23.

159. *Id.* at 224 (internal citations and quotations omitted).

back period insulated the exemption from the cap and rendered the entire value of the property exempt.

## XII. POST-PETITION ATTORNEY'S FEES

### A. *TRAVELERS CASUALTY & SURETY CO. OF AMERICA V. PACIFIC GAS & ELECTRIC CO.*

The issue of whether an unsecured creditor is entitled to an award of attorney's fees for litigating bankruptcy disputes, when the same is based on a pre-petition contract, often arises in bankruptcy proceedings. In *Travelers*, the insurance company incurred attorney's fees related to various matters in the debtor's Chapter 11 case, including the language of the plan.<sup>160</sup> Asserting a right to recovery of the fees under its pre-petition contract with the debtor, the insurance company sought its allowance as part of its pre-petition claim. The bankruptcy court disallowed the claim and held that the insurance company "could not recover attorney's fees incurred while litigating issues of bankruptcy law."<sup>161</sup> The court of appeals affirmed based on the *Fobian* rule,<sup>162</sup> holding that "attorney fees are not recoverable in bankruptcy for litigating issues peculiar to federal bankruptcy law because the fees incurred were related to issues governed exclusively by federal bankruptcy law."<sup>163</sup>

The Supreme Court unanimously reversed, observing that a creditor is entitled to file a claim in the bankruptcy case and that the claim is to be allowed unless it meets one of the disallowed categories provided by section 502(b) of the Code.<sup>164</sup> None of these categories specifically disallows post-petition attorney's fees.<sup>165</sup> A claim's disallowance may therefore only be based on its "unenforceab[ility] against the debtor and property of the debtor . . . for a reason other than because [it] is contingent or unmatured."<sup>166</sup> The Court explained that non-bankruptcy law typically governs the allowance of claims under this section of the Code and that attorney's fees are allowed under the non-bankruptcy law applicable to the situation.<sup>167</sup>

The Court rejected the *Fobian* rule as judge-made law that finds no support in the Code: "[t]he absence of textual support is fatal for the *Fobian* rule. Consistent with our prior statements regarding creditors' entitlements in bankruptcy, we generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed."<sup>168</sup> Critically, the Court specifically refused to ad-

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160. *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 445-47 (2007).

161. *Id.* at 447.

162. *See Fobian v. W. Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991).

163. *Travelers*, 549 U.S. at 447-48 (internal quotations omitted).

164. *Id.* at 449-50.

165. *Id.*

166. *Id.* at 450 (quoting 11 U.S.C. § 502(b)(1) (2006)).

167. *See id.*

168. *Id.* at 452 (internal citations omitted).

dress the applicability and meaning of section 506(b) of the Code, which generally provides for post-petition attorney's fees to the extent that a secured claim is oversecured.<sup>169</sup> The issue had not already been raised and the Court refused to address it for the first time on appeal, leaving unresolved the ultimate allowance of post-petition attorney's fees for unsecured claims.<sup>170</sup> *Travelers* only stands for the proposition that contract-based attorney's fees as an unsecured claim under section 502(b) of the Code are not automatically disallowable merely because they are incurred while litigating issues under the Code. The more important questions—whether the allowance of such fees will survive a challenge under section 506(b) of the Code, and the type of priority that they may be entitled to—remain unanswered.

### XIII. PROPERTY OF THE ESTATE

#### A. REED V. RABE (*IN RE GROTJOHN*)

*In re Grotjohn* is unreported and involves a unique fact pattern; nevertheless, it is included in this article because it affirms the two published opinions of the courts below.<sup>171</sup> The debtor owned, but failed to schedule, certain affirmative causes of action pre-petition. He continued prosecuting those causes of action post-petition and retained counsel to represent him. To raise the necessary funds, the debtor executed an assignment of a one-third interest in the lawsuit to a friend, who then paid tens of thousands of dollars both to the debtor for the law firm and directly to the law firm.<sup>172</sup> The trustee learned of the state court lawsuit, reopened the case, and defeated the debtor's attempt to exempt the state court lawsuit. In the meantime, the state court jury issued a take-nothing verdict against the debtor. The trustee then sued the law firm to recover the funds paid by the debtor's friend under the assignment, arguing that such funds were property of the estate.<sup>173</sup>

The Fifth Circuit analyzed the assignment agreement between the debtor and his friend to determine if it constituted a "transfer" of property of the estate as defined in the Code. The circuit court agreed that absent an abandonment, only a trustee, and not a Chapter 7 debtor, may lawfully transfer property of the estate.<sup>174</sup> Therefore, the purported assignment was a nullity. In determining whether the proceeds of the assignment were property of the estate as the "proceeds" of property of the estate—which represented the crux of the trustee's argument to avoid and recover the funds in question—the circuit court concluded that:

the Debtor never had the legal power or authority to transfer the legal claims at issue, which were the property of the estate. There-

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169. See *id.* at 454-55.

170. See *id.* at 455.

171. Reed v. Rabe (*In re Grotjohn*), 289 F. App'x 702, 703 (5th Cir. 2008).

172. *Id.*

173. *Id.* at 703-04.

174. *Id.* at 705.



fore, no transfer of estate property occurred, so the Transferred Money could not have been, and was not, "proceeds . . . of or from property of the estate" under § 541(a)(6).<sup>175</sup>

The Fifth Circuit, therefore, affirmed both lower courts and held that the trustee could not recover the funds paid to the law firm because those funds never constituted property of the estate.<sup>176</sup> This holding is important for two principle reasons, despite the limited nature of the factual scenario before the court: (1) the Fifth Circuit confirmed that the debtor has no legal ability to transfer property of the estate and that an attempt to do so through a document (as opposed to a physical disposition) is therefore a nullity; and (2) it confirmed that there can be no "proceeds" of property of the estate without a "transfer" of property of the estate in the first instance.

B. *HIGHLAND CAPITAL MANAGEMENT LP V. CHESAPEAKE ENERGY CORP. (IN RE SEVEN SEAS PETROLEUM, INC.)*

This case builds upon the Fifth Circuit's important jurisprudence that distinguishes which causes of action constitute property of the estate.<sup>177</sup> *In re Seven Seas Petroleum, Inc.* continues the long line of cases that includes *S.I. Acquisitions*<sup>178</sup> and *MortgageAmerica*<sup>179</sup> by addressing whether the injuries caused by one creditor to another were property of the estate.

In *In re Seven Seas Petroleum, Inc.*, certain entities purchased a large amount of the secured notes of the debtor, Seven Seas, on the open market, relying, in part, on petroleum reserves estimates filed by the debtor with the Securities and Exchange Commission.<sup>180</sup> Many of the secured notes were held by Seven Seas insiders. After an involuntary bankruptcy and the appointment of a Chapter 11 trustee, the trustee filed suit against the secured lenders to recharacterize a portion of their debt. The trustee filed affirmative fraud claims against Chesapeake, a holder of the secured notes, and the other secured noteholders, alleging breaches of duty and interference with management's duties.<sup>181</sup> The trustee later dropped the tort claims against Chesapeake; ultimately, the trustee and Chesapeake settled, and Chesapeake released some collateral in exchange for a full release by the estate.<sup>182</sup> The settlement was part of the Chapter 11 plan confirmed by the bankruptcy court, and upon its confirmation, Chesa-

175. *Id.* at 705-06.

176. *See id.*

177. *See Highland Capital Mgmt. LP v. Chesapeake Energy Corp. (In re Seven Seas Petrol., Inc.)*, 522 F.3d 575, 578 (5th Cir. 2008).

178. *S.I. Acquisition, Inc. v. Eastway Delivery Serv., Inc. (In re S.I. Acquisition, Inc.)*, 817 F.2d 1142 (5th Cir. 1987).

179. *Am. Nat'l Bank of Austin v. MortgageAmerica Corp. (In re MortgageAmerica Corp.)*, 714 F.2d 1266 (5th Cir. 1983).

180. *See In re Seven Seas Petrol.*, 522 F.3d at 578.

181. *Id.* at 579.

182. *Id.* at 580.

peake was dismissed with prejudice from the trustee's suit.<sup>183</sup>

Pre-petition, the secured noteholders filed a state court action against the party that prepared the petroleum reserves estimates. Post-confirmation, the secured noteholders amended their state court petition to assert claims against Chesapeake, "bringing claims of conspiracy to defraud and aiding and abetting fraud."<sup>184</sup> The petition alleged that Chesapeake and Seven Seas conspired to commit fraud and that Chesapeake aided and abetted breaches of fiduciary duty by the debtor. Chesapeake then removed the state court suit to bankruptcy court, arguing that bankruptcy jurisdiction existed because the claims at issue were property of the estate, and that such claims were released in the confirmed plan.<sup>185</sup>

Reviewing its prior precedent, the Fifth Circuit noted that "[i]f a claim belongs to the estate, then the bankruptcy trustee has exclusive standing to assert it. However, the trustee has no right to bring claims that belong solely to the estate's creditors."<sup>186</sup> "Whether a particular state-law claim belongs to the bankruptcy estate depends on whether under applicable state law the debtor could have raised the claim as of the commencement of the case."<sup>187</sup> Thus, "[i]f a cause of action alleges only indirect harm to a creditor (i.e., an injury which derives from harm to the debtor), and the debtor could have raised a claim for its direct injury under the applicable law, then the cause of action belongs to the estate."<sup>188</sup>

Applying these principles, the circuit court concluded that the causes of action at bar were not property of the estate because they alleged individualized injury in the form of fraud committed against the secured noteholders.<sup>189</sup> The noteholders alleged injuries suffered by them as a result of Seven Seas Petroleum's alleged misrepresentations and conspiracy with others. As the issue was whether the debtor could have brought the claim, the court found it unlikely, if not impossible, that the debtor could have brought a claim essentially against itself for its own misrepresentations on which it could not have relied by definition.<sup>190</sup> As the circuit court explained:

Here the underlying wrong is fraud in connection with the purchase of bonds in the secondary market, and Seven Seas would not have been in a position to assert the bondholders' reliance on any alleged misrepresentations, or to claim to have suffered damages on account of such reliance, as would be necessary to state a claim based on the particular fraud that the bondholders complain of. The same is true for the aiding and abetting fraud claim.<sup>191</sup>

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183. *Id.*

184. *Id.*

185. *Id.* at 581.

186. *Id.* at 584 (internal citation omitted).

187. *Id.*

188. *Id.* (quoting *Schertz-Cibolo-Universal City v. Wright (In re Educators Group Health Trust)*, 25 F.3d 1281, 1284 (5th Cir. 1994)).

189. *See id.* at 585-86.

190. *Id.* at 585-86, 588.

191. *Id.* at 586 (internal citation omitted).

Of additional importance, the Fifth Circuit noted that: “[w]e also wish to dispel any notion that a claim belongs to the estate or is otherwise only assertable by the trustee merely because it could be brought by a number of creditors, instead of just one.”<sup>192</sup> The issue was not whether more than one creditor could have brought the claim, but rather whether the debtor itself could have brought the claim. This is an important distinction and one which may have broader implications.

Ultimately, *In re Seven Seas Petroleum, Inc.* is an important decision not because it changes the analysis of what causes of action constitute property of the estate, as the Fifth Circuit reiterated and applied its prior precedent on this issue. Rather, it is significant for the manner in which it addresses alleged claims by one group of creditors against another and in the analysis of the debtor’s role in those claims. It is also significant for the close inspection and reliance it gives to the precise language of the petition, and therefore the alleged injury, as pled by the plaintiff. In short, through careful and narrow pleading, a plaintiff may be able to state a sufficiently particularized injury so as to make the claim not property of the estate, assuming, of course, that the claim as so pleaded could survive.

#### XIV. SANCTIONS—RULE 11

##### A. *THE CADLE CO. V. PRATT (IN RE PRATT)*

Bankruptcy Rule 9011 provides that a motion for sanctions regarding a challenged pleading may not be presented to the court unless, within twenty-one days of service of the motion, the challenged paper is not withdrawn.<sup>193</sup> After an adverse ruling, the creditor in *In re Pratt* learned that certain information elicited from the debtor by the debtor’s attorney may have been false.<sup>194</sup> For unexplained reasons, the creditor sought sanctions from the debtor’s attorney under Bankruptcy Rule 9011. The bankruptcy court denied the motion for sanctions because, among other things, the creditor failed to comply with the twenty-one day notice provision of the rule.<sup>195</sup>

The Fifth Circuit observed that it was undisputed that the creditor failed to transmit the motion to the debtor’s attorney at least twenty-one days prior to filing the motion with the bankruptcy court. However, the creditor argued that it complied with the mandatory notice requirement by sending warning letters to the attorney, thereby informing the attorney of the possibility that the creditor would seek sanctions and allowing the attorney to change his pleadings prior to filing the motion.<sup>196</sup>

The Fifth Circuit rejected this argument.<sup>197</sup> The circuit noted that, al-

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192. *Id.* at 588.

193. FED. R. BANKR. P. 9011(c)(1)(A).

194. *The Cadle Co. v. Pratt (In re Pratt)*, 524 F.3d 580, 583 (5th Cir. 2008).

195. *Id.*

196. *Id.* at 586.

197. *Id.*

though the issue of informal notice under the rule (or its equivalent in the Federal Rules of Civil Procedure) was a matter of first impression, other circuit courts had rejected similar informal notice arguments.<sup>198</sup> The circuit also considered the plain language of the rule and noted that it has consistently required “strict compliance” with the rule.<sup>199</sup> The strict compliance required to obtain relief under the rule is rooted in: (1) the potentially severe nature of the rule; and (2) safe harbor provisions of the rule, which are designed to protect litigants wherever possible in order to mitigate Rule 9011’s potentially chilling effect.<sup>200</sup>

Accordingly, informal notice will not suffice under Rule 9011: a party seeking sanctions for a sanctionable position must provide the offending party at least twenty-one days notice and an opportunity to cure the sanctionable conduct prior to filing the motion.<sup>201</sup> Since one cannot provide notice of a filed motion without filing the motion, but may not file the motion until the requisite period has expired, the best practice is to send the offending party a complete, but un-filed, draft of the motion.

#### B. *IN RE SUGAR HILL RESIDENTIAL DEVELOPMENT, INC.*

This case<sup>202</sup> does not present any new point of law and is not likely to be cited as precedent, even if published.<sup>203</sup> However, it is worth mention, as it demonstrates what can happen when an attorney hurriedly files a petition for tactical gain, and then allegedly ignores the case when the tactical gain is lost. It should serve as a reminder to attorneys of the increasing level of scrutiny being shown by some courts, and of attorneys’ continuing duties in bankruptcy cases they file.

In order to forestall a state foreclosure of millions of dollars of unimproved real property, the attorney filed a Chapter 11 petition the day before the scheduled foreclosure.<sup>204</sup> However, the attorney filed the petition for the general partner, which did not own the land. The creditor, realizing that the automatic stay did not apply to non-estate property, continued the foreclosure proceedings. The attorney’s failure to comply with certain requirements prompted a closer review by the United States Trustee and the court.

The court found that the bankruptcy petition was not filed in good faith but instead in order to delay the foreclosure.<sup>205</sup> This finding is potentially significant, since many cases are filed under these circumstances. The court further found that the attorney knew or should have known that the

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198. *Id.* at 586-87.

199. *Id.* at 588.

200. *See id.* at 586-87.

201. *See id.* at 588.

202. *In re Sugar Hill Residential Dev., Inc.*, No. 08-31459 (Bankr. S.D. Tex. Sept. 3, 2008) (order imposing sanctions and referring counsel to District Court and to State Bar of Texas).

203. The case is currently on appeal.

204. *Id.* at 8.

205. *Id.*

debtor did not own the land, and that the attorney instead scheduled the land as an asset of the estate in order to mislead the court and the foreclosing creditor.<sup>206</sup> The attorney filed for the incorrect entity because his ownership in the correct entity would have precluded his representation of the limited partnership. Ultimately, the court sanctioned the attorney \$15,000 and referred the attorney to the State Bar of Texas and to the district court for disciplinary action.<sup>207</sup>

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206. *Id.* at 8-9.

207. *Id.* at 12-13.