MCLE Article: Test Your Knowledge: Recent Developments in Insolvency Law

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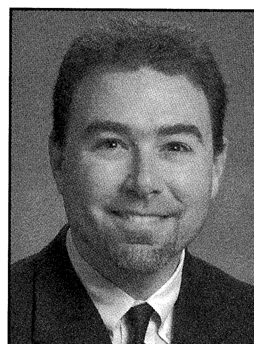

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Welcome to the fourth annual edition of our article covering developments in bankruptcy law. This article comes from a program we presented for the Bankruptcy and Commercial Law Section of the Sacramento County Bar Association. Once again, we invite you to test your knowledge of recent developments in the area of insolvency law. Unless otherwise noted, all references are to the Bankruptcy Code. We provide a summary of the facts, issues and holdings from a mix of important and interesting bankruptcy decisions over the past year. For MCLE credit, please see instructions for accessing the 20 true/false questions at the end of the article. Good luck!

1. Absolute Priority Rule in Individual Chapter 11 Cases: Zachary v. Cal. Bank & Tr., 811 F.3d. 1191 (9th Cir. 2016)

This case involves whether the absolute priority rule codified in Bankruptcy Code section 1129(b) survived the 2005 amendments to the Bankruptcy Code commonly known as BAPCPA. Many courts are divided on whether it did, but the Ninth Circuit Court of Appeals finally decided the issue in early 2016.

In *Zachary v. California Bank & Trust*, the Debtors proposed a plan of reorganization that put their largest unsecured creditor, California Bank & Trust ("Bank"), into a separate class and proposed to pay it $5,000 on a claim of nearly $2,000,000. The Bank objected on the ground that the plan violated the absolute priority rule of § 1129(b)(2)(B)(ii). The bankruptcy court sustained the objection, disagreeing with the Ninth Circuit Bankruptcy Appellate Panel ("BAP") opinion in *In re Friedman*, 466 B.R. 471 (B.A.P. 9th Cir. 2012) holding that the absolute priority rule was abrogated by Congress in BAPCPA. The bankruptcy court certified the appeal, and the Ninth Circuit authorized a direct appeal pursuant to 28 U.S.C. §§ 158(a) & (d)(2)(A).

The absolute priority rule, as it applies to a class of unsecured creditors, provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property under a reorganization plan. Before the adoption of BAPCPA, it was clear that a chapter 11 plan could not be confirmed over the creditors' legitimate objections if it failed to comply with the absolute priority rule.

However, BAPCPA added § 1115 to the Bankruptcy Code, essentially modifying § 541 to provide that property an individual chapter 11 debtor acquires after the commencement of the case also becomes property of the estate. BAPCPA also amended § 1129(b)(2)(B)(ii) by adding a new clause allowing an individual debtor to retain certain property acquired after the commencement of the case. Basically, that amendment says that in a case in which the debtor is an individual, the debtor may retain property included in the estate under § 1115.

The court noted that these amendments plainly create an exception to the absolute priority rule that applies only to individual chapter 11 cases. According to the court, the question to answer was the scope of that exception. Stated another way, what property may an individual chapter 11

debtor retain under a plan without violating the absolute priority rule?

On direct appeal, the Ninth Circuit affirmed the bankruptcy court's ruling that the absolute priority rule survived the BAPCPA amendments and the plan could not be confirmed. The court adopted the "narrow" view that an individual debtor may not cram down a plan that would permit the debtor to retain pre-petition property that is not excluded from the estate by § 541, but may cram down a plan that permits the debtor to retain only post-petition property brought into the estate by § 1115.

While many insolvency law practitioners thought this case was an opportunity for the Ninth Circuit to decide whether BAP decisions are binding on the bankruptcy courts in the circuit where the BAP sits, the court declined to so rule.

On the merits, the court examined the so-called "broad" view adopted by the BAP in *In re Friedman*. That view holds that the new clause in § 1129(b)(2)(B)(ii) means Congress intended to include the entirety of the bankruptcy estate as property that the individual debtor may retain, because § 1115 references § 541. Because § 1115 references § 541, the argument goes, Congress intended that an individual debtor could retain all property under a plan, not just property acquired post-petition. That reading of § 1115 effectively abrogates the absolute priority rule in chapter 11 for individual debtors.

The "narrow" view is the view the Ninth Circuit adopted here. It also is the majority view among the circuit courts, district courts, and bankruptcy courts that have addressed the issue. Under the "narrow" view, an individual debtor may not cram down a plan that would permit the debtor to retain pre-petition property that is not excluded from the estate by § 541, but may cram down a plan that permits the debtor to retain only post-petition property brought into the estate by §1115.

The court said the key is determining what the word "included" means in the clause in § 1129(b)(2)(B)(ii) stating that "the debtor may retain property included in the estate under section 1115." The court agreed with the Sixth Circuit's analysis of the word in *Ice House Am., LLC v. Cardin*, 751 F.3d 734, 736 (6th Cir. 2014), that "included" should be interpreted as "to take in." Viewing "included" as "to take in," the court found that § 1129(b)(2)(B)(ii) provides that "the debtor may retain property that § 1115 takes into the estate." Thus, what § 1115 takes into the estate is property that the debtor acquires after the commencement of the case, and it is only that property that the debtor may retain when her unsecured creditors are not fully paid.

To further support its interpretation, the court also noted that the U.S. Supreme Court has expressly warned against finding implied repeal of provisions of the Bankruptcy Code, citing *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 380 (1988). Thus, the Ninth Circuit affirmed the bankruptcy court's ruling denying confirmation of the plan because it violated the absolute priority rule.

2. Attorneys' Fees Awarded to Chapter 13 Debtor Against a Creditor Based Upon California Civil Code section 1717: In re Penrod, 802 F.3d 1084 (9th Cir. 2015).

The rule in the Ninth Circuit relating to claims for contract-based attorneys' fees incurred in bankruptcy disputes used to be governed by the relatively simple "Fobian Rule."[1] Under this rule, claims for attorneys' fees arising from litigating issues that are "peculiar to federal bankruptcy law," rather than contract enforcement issues, generally were *not* recoverable. However, in *Travelers*,[2] the U.S. Supreme Court rejected the Ninth Circuit's long-standing Fobian Rule. Instead, the Court stated the general rule that "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." The Ninth Circuit recently explored the contours of recovering contract-based attorneys' fees in bankruptcy litigation in *In re Penrod*,[3] and awarded the debtor its very substantial attorneys' fees for prevailing in litigation against a creditor relating to the debtor's chapter 13 plan.

The facts in *Penrod* were that the debtor ("Debtor") had a car worth $6,000, on which she owed $13,000, leaving $7,000 in "negative equity." A car dealer ("Creditor") sold the Debtor a new car, and included in the car loan the full purchase price of the new car, plus the $7,000 in negative equity. When the Debtor filed a chapter 13 bankruptcy petition two years later, the value of her car was $16,000, and the car loan totaled $26,000. She sought confirmation of a chapter 13 plan that initially bifurcated Creditor's claim into a $16,000 secured claim (i.e., the value of the car) and a $10,000 unsecured claim. She later amended her plan to bifurcate Creditor's claim

into a purchase-money secured claim for $19,000, and an unsecured claim for the "negative equity" portion of $7,000, which the Debtor contended was the non-purchase money portion of the loan.

Creditor objected to the Debtor's plan on that grounds that the "hanging paragraph" after 11 U.S.C. § 1325(a)(9)[4] protects auto lenders from any bifurcation of a lien into secured and unsecured portions when the lien is a "purchase money security interest" in a motor vehicle recently acquired for the debtor's personal use. The bankruptcy court overruled the objection and held that the "purchase money security interest" did *not* include the $7,000 amount attributable to the negative equity. Instead, the "negative equity" portion of the secured claim was properly treated as an unsecured claim in the Debtor's plan. The Creditor appealed to the Bankruptcy Appellate Panel, which affirmed, and then again to the Ninth Circuit, which affirmed again.

Meanwhile, the Debtor had incurred some $240,000 in attorneys' fees in what had become a major fight with the Creditor. She filed a petition with the bankruptcy court to recover these fees. The car loan contract stated that in the event of a default, "[y]ou will pay our reasonable costs to collect what you owe, including attorney fees, court costs, collection agency fees, and fees paid for other reasonable collection efforts." Thus, the contract contained a one-sided attorney fee provision in favor of the Creditor. The Debtor requested attorneys' fees based upon California Civil Code section 1717, which provides that one-sided attorney fee provisions are deemed to be reciprocal, but only when the attorneys' fees were incurred in "actions on a contract." The bankruptcy court denied the debtor's request for fees, and concluded that she did not prevail in an action "on a contract" because her success in the litigation turned not on an issue of state law, but on a question of federal bankruptcy law (i.e., the interpretation of the "hanging paragraph"). The district court affirmed.

The Ninth Circuit reversed, and held that the hanging-paragraph litigation did in fact constitute an action "on a contract" under California Civil Code section 1717, and that the Creditor was seeking to enforce the provisions of its contract when it objected to confirmation of the proposed plan. The court relied on the *Travelers* decision, which as noted above, held that nothing in the Bankruptcy Code expressly disallows claims for attorneys' fees simply because the fees are incurred litigating questions of federal bankruptcy law. The Ninth Circuit concluded that California law supports the proposition that section 1717 is broad enough to provide for attorneys' fees when a party successfully limits enforcement of a contract solely on the basis of federal bankruptcy law. The court remanded for a determination of the reasonable amount of an attorney fee award.

3. Necessity of Court Approval Prior to Payment of Administrative Claims: In the Matter of Cloobeck, 788 F.3d 1243 (9th Cir. 2015)

This case involves the necessity of obtaining court approval before payment of administrative claims under section 503(b) of the Bankruptcy Code. This case likely changed the practice of many trustees in administering chapter 7 cases.

In *Matter of Cloobeck*, the debtor's case started as a chapter 11 filed in January 2005, but was converted to chapter 7 in late 2005. After conversion, the chapter 7 trustee paid $340,895 of estate funds to the Internal Revenue Service to satisfy the estate's 2005 federal income tax liability. The trustee did not give notice, or seek a hearing, before making the 2005 tax payment, nor did the bankruptcy court authorize the payment of 2005 taxes before the trustee made the payment. A creditor holding an approximately $1 million claim objected to the trustee's final report in 2012, on the ground that the trustee should have obtained court approval after notice and a hearing before paying an administrative claim.

At the hearing on the objection to the final report, the bankruptcy court found that the trustee acted appropriately with respect to the handling of the taxes and approved the final report. The creditor appealed to the district court. The district court affirmed, holding that the creditor's objection to the payment was untimely since it knew of the payment back in 2009 and did nothing until three years later when it objected to the trustee's final report. The creditor appealed to the Ninth Circuit Court of Appeals.

The Ninth Circuit agreed that the trustee had obligations under the Bankruptcy Code and the Internal Revenue Code to pay the taxes when due. The court had a simple response: Both court approval and timely payment can be accomplished.

The court rejected the trustee's argument that the creditor's objection was untimely since it knew about the payment of the taxes in 2009. The court was satisfied with the creditor's diligence, since the first time the trustee had formally filed anything seeking approval of the payment was the filing of the final report.

Basically, the taxes were administrative expenses, so the trustee needed court approval to pay them under § 503(b). § 503(b) clearly provides that administrative expenses shall be allowed only "[a]fter notice and a hearing."

On first glance, there would seem to be no reason why this case would not apply equally to chapter 11 trustees and debtors in possession. § 503 certainly applies in chapter 11 cases. One might argue that certain tax payments by an operating debtor or by a trustee operating a debtor would be ordinary course of business payments authorized under §363(c)(1) (e.g., sales and payroll taxes). § 363(c)(1) provides that if the business of the debtor is authorized to be operated, a trustee may enter into transactions in the ordinary course of business without notice or a hearing. But it would seem that not all tax payments meet the "ordinary course of business" test under § 363(c)(1).

4. Bankruptcy Court Lacks Jurisdiction to Hear Action to Revoke Discharge Brought More Than One Year After Discharge: In re Elliott, 529 B.R. 747 (B.A.P. 9th Cir. 2015).

In *In re Elliot*,[5] the Bankruptcy Appellate Panel ("BAP") addressed the sometimes difficult question of when a statute of limitations can be waived by a defendant, and when the statute is "jurisdictional" and non-waivable. In this case, a creditor obtained a judgment against debtor and apparently recorded an abstract of judgment. Debtor then transferred his residence to a series of two related entities. Later, the debtor filed a chapter 7 petition, and did not disclose his residence or include the creditor on his Schedules. After his discharge was entered and the case closed, the related entity transferred the residence back to debtor. Debtor then contacted the creditor, explaining he had acquired the residence, and demanded that it remove its judgment lien.

Upon investigation, the creditor discovered the debtor's ties to the residence and requested that the bankruptcy case be re-opened. The reappointed chapter 7 trustee filed an action to revoke the debtor's discharge under § 727(d), based upon fraud. Although the action was brought more than one year after the discharge had been entered, the debtor did *not* assert § 727(e) as a defense – this statute provides that the trustee "may request revocation of a discharge within one year after such discharge is granted." The bankruptcy court revoked the debtor's discharge. The debtor appealed.

The BAP reversed, and held that § 727(e) is both a grant to, and limitation on, a bankruptcy court's subject matter jurisdiction over discharge revocation actions. The court described § 727(e) as a "non-waivable statute of repose," and that its time limits are not subject to tolling. As a result, the failure to commence a § 727(d) adversary proceeding within the time period specified in § 727(e), the court held, deprives the bankruptcy court of jurisdiction to adjudicate that action.[6]

Note that the rule is different when an action is brought to deny (vs. revoke) a discharge. The deadline to file an action to *deny* a discharge is governed by Bankruptcy Rule 4004(a). The Supreme Court ruled in the *Kontrik* case[7] that the Rule 4004(a) time limit for an action to deny a discharge does not constitute a "jurisdictional" limitation, but rather should be treated in the same fashion as an affirmative defense, which is subject to forfeiture if not timely raised by the debtor.

5. Employer's Status as Fiduciary for Benefit Plan Payments Due: Bos v. Bd. of Tr., 795 F.3d 1006 (9th Cir. 2015)

This case involves the question of whether an employer has a fiduciary duty to make payments to employee benefit plans such that non-payment would qualify as fraud or defalcation while acting in a fiduciary capacity under § 523(a)(4), rendering the debt nondischargeable in bankruptcy.

In *Bos v. Board of Trustees*, Mr. Bos was owner and president of Bos Enterprises, Inc. ("BEI"). As president of BEI, Bos agreed that BEI would be bound by the Carpenters' Master Agreement and several trust agreements. The Carpenters' Master Agreement required each employer—including BEI—to contribute monthly payments based on hours of work to the trust funds (the "Funds") for the purpose of providing employee benefits.

It was undisputed that Bos personally had full control over BEI's finances, as well as authority to make

payments on behalf of BEI, whether to the Funds or to other creditors. BEI struggled to make the payments required by the Carpenters' Master Agreement. Bos signed a promissory note personally guaranteeing payment to the Funds of $359,592.09—the amount he had failed to pay from August 2008 through January 2009. A subsequent arbitration award set the amount due from Bos and BEI at $504,282.59.

Thereafter, Bos filed a chapter 7 bankruptcy case. The Board of Trustees for the Funds filed a complaint against Bos contesting the dischargeability of the $504,282.59 debt under § 523(a)(4). § 523(a)(4) excepts from discharge debts incurred due to a debtor's fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. The bankruptcy court and the district court concluded that Bos' debt was nondischargeable under §523(a)(4), because he controlled money that was contractually required to be paid to the Funds. Specifically, each court concluded that because the trust agreements defined the Funds as including contributions "required . . . to be made" to the Funds, the unpaid contributions were plan assets. Because Bos personally had control over BEI's finances and the authority to make contributions to the Funds, he personally exercised the requisite control over the unpaid contributions (i.e., plan assets) to be deemed a fiduciary under ERISA, and therefore under § 523(a)(4) as well.

The Ninth Circuit disagreed with the bankruptcy and district courts. The Ninth Circuit has adopted a narrow view of "fiduciary" for purposes of § 523(a)(4). Following the views expressed by the Sixth and Tenth Circuits, the court declined to hold that an employer is a fiduciary even if the agreements include plan contributions as plan assets. The court viewed the right to the plan contribution itself as a right to collect the payment, which the employer does not hold, as shown in this case, because the Board of Trustees was enforcing the right to payment. Thus, neither Bos nor BEI were fiduciaries as required by § 523(a)(4), and an employer cannot commit defalcation under § 523(a)(4) simply by failing to make contractually required contributions, even if the plan defines the fund as including future contributions.

There is a split in the circuits on this issue. As mentioned, the Sixth, Tenth, and now Ninth Circuit all hold that the employer is not a fiduciary. The Second and Eleventh Circuits, however, follow the reasoning that when the plan agreement makes the contributions part of the trust fund, the employer who had the authority to make the payments is a fiduciary.

6. Order Denying Confirmation of Chapter 13 Plan Is Not a Final Appealable Order: Bullard v. Blue Hills Bank, 135 S. Ct. 1686 (2015)

Most bankruptcy lawyers understand that orders confirming chapter 13 plans are final appealable orders. The U.S. Supreme Court recently settled the related question of whether an order denying confirmation of a chapter 13 plan is a final appealable order, and the answer is no, it is not.

In *Bullard*, the chapter 13 debtor proposed a plan which sought to strip down a lien on the debtor's rental multi-family residence to the value of the property, and treat the balance of the claim as unsecured. The bankruptcy court denied confirmation on the grounds that chapter 13 did not allow the debtor to split the bank's claim into a secured and unsecured portion unless the debtor paid the secured portion in full during the plan period.

The debtor appealed the denial of confirmation to the BAP (1st Cir.). The BAP concluded that the bankruptcy court's denial of confirmation was not a final, appealable order under 28 U.S.C. § 158(a)(1), but exercised its discretion to hear the appeal anyway under 28 U.S.C. § 158(a)(3), which permits interlocutory appeals "with leave of the court." The BAP affirmed on the merits. The debtor appealed to the First Circuit, which dismissed the appeal for lack of jurisdiction. It found that the bankruptcy court's order denying confirmation was not a final order, and thus not appealable, since the debtor remained free to propose another plan.

On further appeal, the Supreme Court affirmed the First Circuit. It held that denial of confirmation with leave to amend is not a final order, because it is only part of the set of proceedings relating to plan confirmation, as long as the debtor can propose an amended plan. The Court reasoned that immediate appeals from orders denying confirmation would result in delays and inefficiencies that requirements of finality are designed to constrain. The Court also relied upon the fact that the statute defining core bankruptcy proceedings lists "confirmations of plans," § 157(b)(2)(L), but omits any reference to denials, thus suggesting that denials of confirmations of plans were not core proceedings. Finally, the Court stated

that a debtor's inability to immediately appeal a denial encourages the debtor to work with creditors and the trustee to develop a confirmable plan.

7. Status of Funds in Possession of Chapter 13 Trustee Upon Conversion to Chapter 7: Viegelahn v. Harris, 135 S. Ct. 1829 (2015)

This case involves the question of the status of funds, collected by a chapter 13 trustee during a chapter 13 case, that have not yet been distributed to creditors at the time the chapter 13 case is converted to chapter 7. Does the chapter 13 trustee distribute the funds on hand to the creditors or turn over the funds to the debtor? This is a question that was important enough that the U.S. Supreme Court decided it in 2015.

The case of *Viegelahn v. Harris* involves approximately $5,500 of post-petition wages that were in the possession of the chapter 13 trustee at the time of the conversion of the debtor's case to chapter 7. The chapter 13 trustee distributed the funds to creditors after the conversion of the case. The debtor sought an order from the bankruptcy court requiring the trustee to refund the money. The bankruptcy court granted the debtor's motion, which was affirmed by the district court. The Fifth Circuit reversed and remanded the case to the district court.

Why was this issue before the Supreme Court? The Fifth Circuit's ruling in *Harris* conflicts with the Third Circuit's decision in *In re Michael*, 699 F.3d 302 (3d Cir. 2012). The Third Circuit held that undistributed plan payments must be returned to the debtor absent bad faith.

Justice Ginsberg delivered the unanimous decision of the court, which focused on the status of the post-petition wages in a chapter 7 case. The Court looked at § 348(f)(1)(A) as indicative of Congress' intent that, absent bad faith, post-petition wages go back to the debtor. § 348(f)(1)(A) provides that property of the estate in a case converted to chapter 7 consists of property of the estate, as of the date of the filing of the initial petition, that remains in possession of or is under the control of the debtor on the date of conversion. Since post-petition wages are not property of a chapter 7 estate in a case that started as a chapter 7, they are not property of a case converted to chapter 7.

The Court also relied upon the provisions of § 348(e), which provides that the services of a chapter 13 trustee are terminated upon conversion. Since the chapter 13 trustee's services are terminated, the Court reasoned that the trustee would have no authority to make payments to creditors. The Court also did not view the return of funds to the debtor as a "windfall," since the debtor is receiving what it would have been able to keep had the case been a chapter 7 in the first place.

The Court also found § 348(f)(2)'s exception for bad-faith conversions instructive. If a debtor converts in bad faith—for example, by concealing assets in "unfair manipulation of the bankruptcy system,"—the converted chapter 7 estate "consist[s] of the property of the [Chapter 13] estate *as of the date of conversion*." § 348(f)(2) (emphasis added).

§ 348(f)(2) penalizes bad-faith debtors by making their post-petition wages available for liquidation and distribution to creditors. Conversely, when the conversion to chapter 7 is made in good faith, no penalty is exacted. According to the Court, shielding a chapter 7 debtor's post-petition earnings from creditors enables the "honest but unfortunate debtor" to make the "fresh start" the Bankruptcy Code aims to facilitate.

8. Relief from Stay Damages Include Attorney Fees Incurred Litigating Amount of Damages: In re Schwartz-Tallard, 803 F.3d 1095 (9th Cir. 2015)

The Ninth Circuit reversed prior precedent in this *en banc* case, and clarified, simplified, and expanded the rule governing the recovery of damages to an individual caused by a violation of the stay.

In this case, the debtor filed a chapter 13 petition. Creditor foreclosed on the debtor's home and purchased the property by credit bid, without first obtaining relief from stay. Debtor filed a motion demanding that creditor reconvey title and requesting damages. The bankruptcy court ordered creditor to reconvey title to the debtor and pay the debtor $40,000 in economic and emotional distress damages, $20,000 in punitive damages, and $20,000 in attorneys' fees.

Creditor reconveyed title to the property, and appealed the damages award. On appeal, the district court affirmed the bankruptcy court.

After succeeding on appeal, the debtor filed a second motion in the bankruptcy court seeking another $10,000 in attorneys' fees and costs incurred defending the appeal. The Bankruptcy Court denied the motion under *Sternberg*

v. Johnston, 595 F.3d 937 (9th Cir. 2010), which held that attorneys' fees incurred litigating a damages award (vs. fees incurred to correct a stay violation) are not recoverable.

The debtor appealed this order, and the BAP reversed. The BAP distinguished *Sternberg* and held that the fees on appeal were allowable, because the creditor continued to argue that there had been no stay violation. The creditor appealed to the Ninth Circuit.

The Ninth Circuit, in an *en banc* ruling, affirmed the award of the additional $10,000 in attorney fees. The court held that allowing a debtor to recoup all fees and costs caused by a stay violation carried out the Congressional intent of the statute, and that a broader rule is simpler and would avoid litigation relating to the bifurcation of costs under the *Sternberg* approach. Notably, the Ninth Circuit did not use the BAP's reasoning, whereby it distinguished *Sternberg*; rather the Ninth Circuit explicitly overruled *Sternberg*. The court found that *Sternberg* improperly construed § 362(k) as limiting the debtor to costs and attorneys' fees incurred to end the stay violation, when such limitation is not expressed in the statute.

A dissenting opinion argued that § 362(k) should not be read to expand the fee-shifting aspects of § 362(k) without clear statutory language or evidence of Congressional intent. A broader allowance of attorneys' fees and costs might also cause an unwelcome increase in litigation, by serving as an extra incentive to bring an action under § 362(k).

9. Proper Balancing Test Under Unclean Hands Doctrine: Northbay Wellness v. Beyries, 789 F.3d 956 (9th Cir. 2015)

This case involves the proper balancing test when both parties have unclean hands. Here, the court tackled the difficult question of whether a debt owed by an attorney who stole funds from a client who had obtained the funds illegally should be nondischargeable.

In *Northbay Wellness v. Beyries*, the debtor Northbay Wellness Group operated a California medical marijuana dispensary in 2005 and 2006. Beyries was on Northbay's board of directors and acted as its attorney. Northbay entrusted Beyries with at least $25,000 of its marijuana sales revenue as a legal defense trust fund. Beyries absconded with the $25,000 trust fund.

Northbay sued Beyries in state court, alleging, among other things, conversion of the legal defense trust fund and breach of contract. A jury found in favor of Northbay, awarding $25,000 for conversion, $319,430.96 for breach of contract, and $5,000 in punitive damages.

Beyries filed a chapter 7 bankruptcy case and listed Northbay as a creditor for the judgment amount. Northbay filed an adversary proceeding against Beyries alleging that the state-court award was nondischargeable under § 523(a).

The bankruptcy court concluded that Beyries' misappropriation of the $25,000 legal defense trust fund ordinarily would be nondischargeable under § 523(a)(4) of the Bankruptcy Code (a debt "for fraud or defalcation while acting in a fiduciary capacity" is not discharged). However, the court held that the doctrine of unclean hands precluded a judgment for Northbay, because Northbay created the trust fund using the proceeds of illegal marijuana sales. The bankruptcy court dismissed the adversary proceeding, and the district court affirmed.

The Ninth Circuit reversed. Citing the Supreme Court decision in *Johnson v. Yellow Cab Transit Co.*, 321 U.S. 383, 387 (1944), the court held that the bankruptcy court failed to apply the proper balancing test when both parties have unclean hands. The Ninth Circuit stated, "determining whether the doctrine of unclean hands precludes relief requires balancing the alleged wrongdoing of the plaintiff against that of the defendant, and 'weigh[ing] the substance of the right asserted by [the] plaintiff against the transgression which, it is contended, serves to foreclose that right.'"

The Ninth Circuit held that if the bankruptcy court had weighed the parties' respective wrongdoing, as opposed to just finding that Northbay had unclean hands, it necessarily would have concluded that Beyries' wrongdoing outweighed Northbay's, both as to harm caused to each other and as to harm caused to the public.

According to the court, since Beyries was involved in the marijuana selling as the attorney for Northbay, that wrongdoing did not tip the balance either way. However, a lawyer stealing from its client is a "gross violation of general morality likely to undermine public confidence in the legal profession and therefore merits severe punishment." The court cited a California Supreme Court decision holding that theft from a client is "an offense which involves moral turpitude and clearly warrants

disbarment in the absence of extenuating circumstances." The court also pointed out that Beyries was disbarred for the conduct at issue here. The court concluded that in the balance of wrongdoing, Beyries' conduct was much worse than Northbay's conduct. Thus, Northbay should have been able to proceed with its nondischargeability complaint against Beyries.

10. Creditor Can Sue Guarantors in Different Actions: DKN Holdings LLC v. Faerber, 61 Cal. 4th 813 (2015)

In this case, the California Supreme Court addressed the recurring issue of rules governing lawsuits against parties that are jointly and severally liable on a contract, and clarified the rule that such parties may be sued in separate actions.

In *DKN Holdings*, a landlord leased commercial space to three individual tenants, who were jointly and severally liable under the terms of the lease. After default, one tenant sued the landlord. The landlord cross-complained against all three tenants but soon dismissed two of them without prejudice. The landlord eventually obtained a large judgment against the first tenant. Just before that first judgment was entered, the landlord brought suit against the second and third tenants in a separate action.

The second tenant demurred on the ground that the landlord's suit against them was barred under the doctrine of claim preclusion, since he had already obtained a judgment against the first tenant. The trial court sustained the demurrer without leave to amend and entered judgment in favor of both the second tenant and the third, who had defaulted.

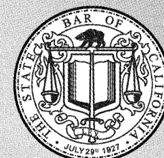
The appellate court affirmed, holding that since both of the landlord's lawsuits had been based on the same "primary right," i.e., the underlying leasehold obligation, the landlord's first suit had to name all of the tenants it wanted to pursue, and could not later bring a separate action against the second and third tenants.

The California Supreme Court reversed, and held that parties who are jointly and severally liable on a contract may be sued in separate actions. Judgment in the first action does not bar judgments in later actions, even when they allege the same claim of wrongdoing, as long as the suits are against different parties. Thus, if one of multiple obligors cannot be joined, because he is outside the court's jurisdiction, for example, the plaintiff is not forced to forfeit the right to recover against such obligor but can pursue such claim in a separate lawsuit.

The court addressed the tenant's argument on appeal that allowing separate actions would be inefficient and would subject the parties to multiple proceedings. As explained by the court:

> This concern is largely answered by the modern doctrine of issue preclusion . . . . [E]ven when multiple suits are permissible, the plaintiff may not relitigate issues decided against him in the first action, including issues related to damages . . . . Yet all defenses remain available to a co-obligor in a later suit, including those rejected in the first suit, because the co-obligor was not a party to the earlier proceeding and thus is not bound by it.

Thus, the court explained that it is not unfair to the tenants to proceed in multiple lawsuits.



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Endnotes

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

2 Travelers Cas. & Sur. Co. of America v. Pac. Gas and Elec. Co., 549 U.S. 443 (2007).

3 Penrod v. Americredit Fin. Servs., Inc. (*In re* Penrod), 802 F.3d 1084 (9th Cir. 2015).

4 Unless otherwise specified, all references to "§" refer to title 11, U.S.C. (the *Bankruptcy* Code).

5 529 B.R. 747 (B.A.P. 9th Cir. 2015).

6 The holding in *Elliott* that the time limit in § 727(e) is "jurisdictional" bears comparison to the Supreme Court's decision in *In re Espinosa*, 559 U.S. 260 (2010). In *Espinosa*, the Court ruled that the 180-day deadline to file a complaint to revoke a chapter 13 plan under § 1330 of the Bankruptcy Code was not jurisdictional and thus was waivable.

7 Kontrik v. Ryan, 540 U.S. 443 (2004).