MCLE SELF-STUDY ARTICLE

TEST YOUR KNOWLEDGE: RECENT DEVELOPMENTS IN INSOLVENCY LAW 2022

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Welcome to the eighth annual edition of our article covering recent developments in bankruptcy law. This article comes from a program we present 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 ten recent important and interesting bankruptcy decisions. For MCLE credit, please answer the 20 true/false questions available at the CLA's website: www. calawyers.org. Good luck!

1. **Profit Motive Not Required for Subchapter V Eligibility: *NetJets Aviation, Inc. v. RS Air, LLC (In re RS Air, LLC)*, No. BAP NC-21-1227-BGT, 2022 WL 1288608 (B.A.P. 9th Cir. April 26, 2022).**

This case involves the requirements and burden of proof for a debtor to be eligible to file a subchapter V chapter 11 case. Subchapter V is a certain type of chapter 11 case for smaller businesses to attempt to reorganize more quickly and efficiently, and with less stringent requirements, than would be possible in a typical chapter 11 case. Section 1182(1)(A) requires that for a debtor to be eligible for subchapter V it must be "engaged in commercial or business activities."

The debtor RS Air's business involved using and providing aircraft transportation services and acquiring and selling interests in aircraft. RS Air's revenue came from providing flight services to its sole owner, flying fragile technology prototypes to prevent damage from commercial baggage handling, and acquiring and selling fractional interests in aircraft. RS Air had agreements to purchase or lease fractional interests in private jets from NetJets Aviation. When one of NetJets aircraft was involved in a runway accident, RS Air ceased doing business with it, so that RS Air was not engaged in its normal flight operations when it filed chapter 11. Prior to bankruptcy, RS Air and NetJets had been involved in state court litigation, and NetJets held 98% of the total non-insider debt against RS Air.

RS Air elected subchapter V status in its chapter 11 case. NetJets objected, asserting that RS Air was not currently "engaged in commercial or business activities" because for years it had no flight operations, no revenue or income, and no employees. NetJets also argued that RS Air had never generated revenue and its sole purpose was to serve as an intermediary through which its owner acquired interests in and used private jets and received depreciation tax benefits. NetJets argued that the burden was on the debtor to establish its eligibility for subchapter V. The debtor argued that ongoing operations, employees, and profitability were not required for

subchapter V eligibility. The debtor also argued that it was currently engaged in business activities by litigating with NetJets, intending to resume negotiating sales of its fractional jet interests, and was paying aircraft registry fees, keeping tax obligations current, and otherwise maintaining good standing as an LLC.

The bankruptcy court overruled NetJets' objection to eligibility, finding that the burden was on NetJets to establish the debtor was not eligible. The court found that the debtor was engaged in sufficient business activities on the petition date by litigating with NetJets, intending to resume fractional jet ownership with a different partner, and remaining in good standing as an LLC. Thereafter, RS Air filed its chapter 11 plan, to which NetJets objected, raising similar arguments in opposition to the plan. The bankruptcy court ruled that even if RS Air had no income, whether it generated income was not determinative. The court refused to revisit the eligibility issue based on law of the case, but noted that its interpretation of what were sufficient business activities for eligibility had been recognized by other courts and that those activities remained viable at confirmation.

NetJets appealed to the Ninth Circuit Bankruptcy Appellate Panel ("BAP"), which affirmed the bankruptcy court.

The BAP concluded that the bankruptcy court erred in ruling that NetJets had the burden on eligibility. That error was harmless because the record supported that the debtor could meet the burden. The BAP recognized that the statute and rules were silent on burden and the issue was one of first impression in the Ninth Circuit. The BAP followed cases regarding eligibility in subchapter V cases around the country in deciding that placing the burden on the debtor was correct.

On the issue of whether a profit motive was necessary for a debtor to be "engaged in business or commercial activity," the BAP found that the trend in subchapter V cases is that litigating, staying in good standing, and keeping current on tax obligations, coupled with the intent to reengage in buying and selling fractionalized interests, met the standards for commercial or business activities. The BAP affirmed the bankruptcy court's factual findings and held that a profit motive was not needed for eligibility.

The BAP also found that the bankruptcy court was entitled to revisit its interlocutory rulings on eligibility when making its final order confirming the plan. The court's refusal to do so here was harmless error since the plan confirmation record independently supported the debtor's eligibility. Thus, the BAP affirmed the bankruptcy court's rulings.

2. A Trustee Cannot Revisit the Value of an Exempt Asset if the Debtor Claimed "100% of FMV" and There Was no Timely Objection: *Masingale v. Muding (In re Masingale)*, No. 22-1016 (B.A.P. 9th Cir. Nov. 2, 2022).

In a case of first impression, the BAP held that a debtor who claims a homestead exemption equal to "100% [of] fair market value" is entitled to retain postpetition appreciation in the value of the property, even if the chapter 11 case converts to chapter 7. The decision may also be important outside the exemption context: the court's analysis suggests that debtors in chapter 13 cases that convert to chapter 7 should retain postpetition appreciation regardless of whether the home was sold before or after conversion.

In *Masingale*, husband and wife debtors filed a chapter 11 petition in 2015. They scheduled their home as being worth about $165,000 and encumbered by a $130,000 mortgage. In the schedules, they claimed an exemption under § 522(d)(1) for "100% [of] fair market value." At the time, the Washington state exemption was $45,900. No one lodged an objection to the exemption claim within thirty days after the first meeting of creditors, as generally required by Federal Rules of Bankruptcy Procedure, rule 4003(b)(1).

In 2017, the debtors confirmed a plan providing that the debtors would keep the home and continue to pay the mortgage until maturity. The plan "appeared to claim [that] the entire fair market value of the home" was exempt, but also indicated that the home would not be exempt until all creditors were fully paid under the plan.

More than one year after plan confirmation, in 2018, the case was converted to chapter 7. Note that under rule 1019(2)(B)(i), a new time period for objecting to exemptions would have arisen if the conversion had occurred less than one year after the plan was confirmed, but here over a year had elapsed. A dispute arose regarding the extent of the debtors' exemption in the home. The bankruptcy court approved a sale of the home for $422,000, generating net sale proceeds of $222,000, and ruled that the debtors' share of the proceeds was limited to $45,900, the amount of the Washington exemption. The court directed the trustee to hold the sale proceeds pending an appeal by the debtors, who claimed the "100% [of] fair market value" exemption meant that they were entitled to all the sale proceeds.

The BAP agreed with the debtors. As a matter of first impression, the court ruled that the debtors' "claim of an exemption equal to '100% [of] FMV' includes postpetition appreciation and becomes incontestable if there is no timely objection." The decision was based upon § 522(l) ("Unless a party in interest objects, the property claimed as exempt

on such list is exempt"); Federal Rules of Bankruptcy, rule 1019(2)(B)(i) (time to object to exemption was not reopened); and Taylor v. Freeland & Kronz, 503 U.S. 638 (1992) ("if no one files a timely objection, an exemption claim is valid even if it had no 'colorable basis' in the law.").

In this case, the debtors had claimed an exemption in the "full market value" of the home, which was wording that the Supreme Court had looked at in Schwab v. Reilly, 560 U.S. 770 (2010). The BAP described the case as holding that a debtor may claim "100% of FMV" to put parties in interest on notice that the debtor intends to claim the full value of the property as exempt, at the time of the petition or later at the time of sale.

The trustee argued that under the established "snapshot rule," the exemption was limited to the value of the property at the time of the filing of the petition and did not include postpetition appreciation. As explained by the BAP:

> The snapshot rule fixes the point in time that defines the exemptions that a debtor is entitled to take. It says nothing about what happens when a debtor claims an exemption in postpetition appreciation to which the debtor is not entitled and no one timely objects. [Emphasis in original.]

To have the benefit of the snapshot rule, the BAP said, "a trustee or party in interest must object to an exemption claim that contradicts that rule." The BAP reversed the bankruptcy court's order that had limited the exemption to the statutory maximum of $45,950 and remanded for the bankruptcy court to determine how to enforce the exemption "and what other remedies, if any, are appropriate."

Finally, on appeal, the trustee argued that the appeal was statutorily moot under § 363(m). The section provides that the "reversal or modification on appeal of an authorization . . . of a sale or lease of property does not affect the validity of a sale or lease . . . to an entity that purchased or leased such property in good faith, . . . unless such authorization and such sale or lease were stayed pending appeal."

The BAP ruled that the appeal was not statutorily moot, because the debtors were only challenging the amount of the exemption claim and the distribution of the proceeds; they were not contesting the validity of the sale, and the trustee was holding funds to pay the debtors if they were to win on appeal. The decision also suggested that the even if the trustee had fully distributed the sale proceeds, this would not of itself be cause for a finding of "equitable mootness" on appeal, which would require an additional showing that it would be impossible or inequitable to claw back those payments from administrative and unsecured creditors.

3. Solvent Chapter 11 Debtor Must Pay Postpetition Interest at Contract or State Law Rates: *In re PG&E Corp.*, 46 F.4th 1047 (9th Cir. 2022).

As most Californians know, Pacific Gas & Electric Company ("PG&E") filed for bankruptcy in 2019 to resolve billions of dollars of wildfire claims. PG&E was a rare "solvent" debtor that was able to preserve its equity interests under its chapter 11 plan ("Plan") while purportedly paying all its creditors in full. Under PG&E's Plan, certain general unsecured creditors were entitled to receive full repayment of the amount of their non-wildfire-related claims in cash, plus all interest accruing on such claims following the date PG&E filed for bankruptcy at a rate equal to the federal judgment rate of 2.59%. PG&E's Plan classified these unsecured creditors as "unimpaired," which meant that class of creditors was "deemed" to accept the Plan without being entitled to vote. Section 1124 of the Bankruptcy Code provides that a claim is impaired unless the bankruptcy plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest."

An ad hoc committee of trade creditors ("Ad Hoc Committee") objected to PG&E's Plan on the ground that the Plan's application of the federal judgment rate to calculate postpetition interest was incorrect and thus the treatment rendered the class of trade creditors impaired under the Plan. The Ad Hoc Committee argued that the proper interest rate for a solvent chapter 11 debtor is the rate provided for in their prepetition contracts. The bankruptcy court disagreed, relying on its interpretation of the Ninth Circuit Court of Appeal's decision in *In re Cardelucci*, 285 F.3d 1231 (9th Cir. 2002). The bankruptcy court found that in *Cardelucci* "the Ninth Circuit held that in Chapter 11 cases involving solvent debtors, unsecured creditors are entitled to postpetition interest at the federal judgment rate, not at contractual or state statutory rates" and that such rule is not "limited to impaired claims" but instead has "broad application" to unimpaired claims as well. The bankruptcy court rejected the argument that holders of unimpaired claims should receive interest on their claims at a rate different from the rate applicable to impaired claims, finding that *Cardelucci* "drew no distinction as to whether the rule it announced was confined only to impaired claims" and that the Bankruptcy Code, not the debtors' plan, limited unimpaired creditors' rights to postpetition interest at the federal judgment rate only.

The district court affirmed the bankruptcy court's opinion on similar grounds. On appeal, the Ninth Circuit reversed.

No circuit court had previously addressed the question, but two bankruptcy court decisions had come to opposite conclusions. *See In re* Ultra Petroleum Corp., 624 B.R. 178, 203-04 (Bankr. S.D. Texas 2020) (unimpaired creditors are entitled to postpetition interest at the contract rate); *In re* The Hertz Corp., 637 B.R. 781, 800-01 (Bankr. D. Del. 2021) (unimpaired creditors are entitled to postpetition interest only at the federal judgment rate). The court first analyzed the solvent debtor exception, finding that the exception from 18th century common law required debtors "to pay interest that accrued during bankruptcy before retaining value from an estate," and that the exception was applied with regularity and was "well-established" under the Bankruptcy Act (the predecessor to the current Bankruptcy Code).

The Ninth Circuit then held that the lower courts misinterpreted *Cardelucci* as applying to unimpaired creditors. The court found that *Cardelucci* applies only to the interpretation of "the legal rate" in section 726(a)(5), which applies only in chapter 7 cases or to impaired chapter 11 claims through section 1129(a)(7) (known as the best interests test). The court held that *Cardelucci* "does not apply to unimpaired claims" and "does not answer what rate of interest is required where § 726(a)(5) does not apply—including for unimpaired claims."

The court stated that "in most solvent-debtor cases involving unimpaired creditors," bankruptcy courts should "enforce creditors' rights according to the tenor of the contracts that created those rights" and apply the applicable contract rate to the calculation of postpetition interest. However, the court noted that "compelling equitable considerations could counsel in favor of payment of postpetition interest at a different rate" than the contract rate, so, even though the court saw "no sign of any compelling equitable considerations in this case," it noted the limited factual record before it and remanded the case to determine the proper interest rate.

The Ninth Circuit stayed its mandate remanding the matter while PG&E seeks certiorari from the Supreme Court. By the time this article is published, it is likely that the Supreme Court will have acted on that request.

4. **In Nondischargeability Action, the Court Must Rule on Contract Issues to Shift Fees under California's "Reciprocity" Statute, Civil Code section 1717: *Bank of the West v. Curtis (In re Curtis)*, No. 21-55850, 2022 WL 1439131 (9th Cir. May 6, 2022).**

California is one of the minority of states with a "reciprocity" statute, Civil Code section 1717, which provides that a one-sided contractual obligation to pay attorneys' fees (often drafted in favor of a lender) is treated as reciprocal if there is later an action "on the contract." Under California law, if an action asserts both contract and tort or other noncontract claims, section 1717 applies only to attorney fees incurred to litigate the contract claims. Santisas v. Goodin, 951 P.2d 399, 406-07 (Cal. 1998). This has raised vexing questions about how this applies to nondischargeability proceedings under § 523, which commonly include a mix of issues relating to underlying contracts and the creditor's effort to prove some version of a fraud tort by the debtor. In general, bankruptcy courts are tasked with assessing to what extent a state court would award fees to a prevailing party in a tort action, and then may use that approach in a nondischargeability action based on that tort.

The Ninth Circuit recently weighed in again on this area of the law, and, in a nonprecedential disposition, reversed the bankruptcy court and held that the prevailing debtor was not entitled to attorneys' fees because the nondischargeability proceeding was not an action "on a contract."

In the *Curtis* case, the debtor guaranteed two loans from bank to the debtor's solely owned corporation. After corporation defaulted on the loans, bank agreed to a forbearance agreement for six months in exchange for certain payments, guarantees, and financial disclosures from debtor.

Two months later, debtor filed a chapter 7 bankruptcy. Bank filed a complaint asserting that debtor's debt to it was nondischargeable due to alleged misrepresentations in the financial statements provided to bank in connection with the forbearance agreement. Debtor moved for summary judgment, which the bankruptcy court denied, finding there were factual disputes regarding the interpretation and enforceability of the forbearance agreement.

Debtor filed a second motion for summary judgment based on bank's lack of evidence regarding reliance and damages. The bankruptcy court granted that motion, ruling that bank failed to provide necessary evidence of damages caused by alleged lost collection remedies. Debtor then filed a motion for some $87,000 in attorney's fees under Civil Code section 1717. The bankruptcy court granted the motion. Bank appealed to the district court, which reversed. On further appeal, the Ninth Circuit affirmed the district court because the action was not "on a contract."

The Ninth Circuit previously held that fee-shifting applies only if the court "needed" to determine the enforceability of the contract in ruling on dischargeability. *See* Ford v.

Baroff *(In re* Baroff*)*, 105 F.3d 439, 442 (9th Cir. 1997). Citing to that precedent, the Ninth Circuit held in this case that the debtor had prevailed on a tort theory (failure to prove damages caused by alleged fraudulent forbearance agreement) and that an "interpretation of the agreement was not necessary for [the debtor] to prevail, and he did not prevail 'on a contract' within the common-sense construction of the statute." The bankruptcy court made "no ruling, concerning either a legal question or factual dispute, that prevented the enforcement of any term of the agreement." Thus, the proceedings were not an "action on a contract."

5. **Bankruptcy Court's Order Denying Relief from Stay Can Be an Appealable Final Order: *In re Mayer*, No. 2:21-bk-06572-DPC, 2022 WL 679085 (9th Cir. 2022).**

This case involves the question of whether a bankruptcy court's denial of a motion for relief from the automatic stay "without prejudice" is a final appealable order under 28 U.S.C. § 158(a).

In the 1990's, Harrington and Mayer formed two entities: Nexum Development Corp. and Terrian, LLC. In September 2010, Mayer sued Harrington in state court to dissolve Nexum and for breach of fiduciary duty. Harrington countersued. In August 2011, Mayer's sister, on behalf of the Mayer Family Trust, sued Terrian, Harrington, Mayer, and the manager of Terrian. Harrington countersued Mayer's sister and Mayer. The state court consolidated these actions and scheduled trial for October 4, 2017.

On September 29, 2017, Mayer filed a chapter 7 bankruptcy in the Southern District of California, which, by virtue of the automatic stay arising on the commencement of a bankruptcy case, stayed the state court proceedings. Harrington filed an adversary proceeding in the bankruptcy court seeking denial of Mayer's discharge and for nondischargeability of his debts to Harrington under §§ 727(a) & 523(a), respectively. Section 523 provides for the nondischargeability of certain specific debts, while § 727(a) provides grounds to deny the discharge of all the debtor's debts.

In September 2018, Harrington filed a motion for relief from the automatic stay so he could proceed with the state court action. Mayer's chapter 7 trustee urged the court to grant the motion, as well as his own motion to approve two agreements with Harrington. These agreements would give Mayer's bankruptcy estate an interest in any recovery Harrington might obtain from Mayer in the state court litigation. Finding that it required additional information, the bankruptcy court denied the trustee's motion to approve the agreements without prejudice and continued the hearing on Harrington's motion for relief from stay.

On June 16, 2020, the bankruptcy court approved the trustee's agreements with Harrington, but denied Harrington's relief from stay motion "without prejudice." Harrington filed a motion for leave to appeal, which the district court denied on the grounds that the stay motion was denied without prejudice and Harrington failed to establish a right to an interlocutory appeal. Harrington appealed to the Ninth Circuit, arguing that denial of his relief from stay motion was indeed a final order that was immediately appealable.

The Ninth Circuit reversed the district court's denial of the motion for leave to appeal, holding that under the United States Supreme Court's decision in *Ritzen Group, Inc. v. Jackson Masonry, LLC*, 589 U.S. ___, 140 S. Ct. 582, 205 L. Ed. 2d 419 (2020) and prior Ninth Circuit precedent, the bankruptcy court's order denying relief from stay conclusively resolved the requested relief sought by Harrington and was therefore a final and appealable order under 28 U.S.C. § 158(a).

The court initially explained that, contrary to "ordinary civil litigation," the rules governing a determination of finality in bankruptcy cases are "somewhat relaxed." This is because "[a] bankruptcy case encompasses numerous 'individual controversies, many of which would exist as stand-alone lawsuits but for the bankrupt status of the debtor.'" *Ritzen*, 140 S. Ct. at 586. Thus, "[o]rders in bankruptcy cases qualify as 'final' when they definitively dispose of discrete disputes within the overarching bankruptcy case."

While the Supreme Court recently held in *Ritzen* that denial of a stay motion is immediately appealable "when it 'conclusively resolve[s] the movant's entitlement to the requested relief,'" it did not decide whether denial of a stay motion "without prejudice" is a final order.

Here, the Ninth Circuit concluded that the trial court "unreservedly denied" the stay motion, leaving no doubt that, unless a future stay motion were filed for a purpose other than Harrington's continued state court litigation, the motion would be denied. The trial court conclusively resolved the discrete issue raised by Harrington's stay motion, which was whether he could proceed with the state court action. The bankruptcy court's ruling that Harrington's nondischargeability and discharge claims would be resolved in the bankruptcy court, rather than in state court, "resolve[d] and seriously affect[ed] substantive rights and ... finally determine[d] the discrete issue to which it [was] addressed."

While the court reversed the district court's ruling that the order denying the relief from stay motion was not appealable, in a separate and unpublished decision the court also held that the bankruptcy court did not abuse its discretion by denying Harrington's motion for relief from stay.

6. Trustee May Not Avoid a Tax Lien Attached to Exempt Property: *United States of America v. Warfield (In re Tillman)*, No. 21-16034, 2022 WL 17073615 (9th Cir. Nov. 18, 2022).

In a lengthy 2-1 published opinion, the Ninth Circuit held that the chapter 7 trustee could not use the provisions of § 724(a) to avoid and recover for the benefit of the estate a tax penalty lien against the debtor's homestead. The decision held that, due to the exemption, the debtor had withdrawn the residence from the estate, which meant that the trustee could not avoid the lien under § 724(a). There was a strong dissent which argued that an exemption merely withdraws from the estate "an interest" in property, not the property itself, and that the provisions of the statute were clear and did not allow for the result reached by the majority, even though, admittedly, avoidance of the lien could lead to the debtor in effect paying the debt twice.

The debtor filed a chapter 7 petition. She owned a residence worth $475,000, subject to both a deed of trust in the amount of about $375,000 and an IRS tax penalty lien of about $25,000. The debtor claimed a $150,000 homestead exemption under Arizona law, and thus the equity in the property was exempt, subject to the potential issue raised by the trustee.

The trustee filed an adversary proceeding under the provisions of § 724(a), which authorizes the avoidance of tax penalty liens, and to recover the value of the lien for the benefit of the estate under the provisions of § 551 (lien avoided under § 724 is "preserved for the benefit of the estate but only with respect to property of the estate"). There was no dispute that the lien at issue was for a tax "penalty," and thus subject to avoidance in that regard. However, the IRS and the debtor objected, responding that lien avoidance and preservation under §§ 724(a) & 551 did not apply to liens encumbering exempt property.

The bankruptcy court agreed with the trustee that it was entitled to avoid the tax lien. Among other support for its ruling, the bankruptcy court cited § 522(c)(2)(B), which provides that exempt property remains liable for tax liens, and thus it held that the debtor's homestead exemption was ineffective against the tax lien, which the trustee recovered for the estate's benefit. The IRS appealed to the district court, which affirmed, then to the Ninth Circuit, which reversed.

During the pendency of the appeal, the bankruptcy court approved the sale of the residence for $475,000. After paying the mortgage, about $26,000 relating to the tax lien was set aside pending a resolution of the appeal, and the balance of $30,000 was paid to the debtor on account of her homestead exemption.

The decision turned primarily on the interpretation of the applicable portions of §§ 724, 726 and 551. Section 724(a) provides "[t]he trustee may avoid a lien that secures a claim of a kind specified in section 726(a)(4) of this title." Section 726(a)(4) specifies "*property of the estate* shall be distributed ... in payment of any allowed claim, whether secured or unsecured, for any fine or forfeiture." Finally, § 551 states "[a]ny transfer avoided under section ... 724(a) of this title ... is preserved for the benefit of the estate but only with respect to property of the estate."

The Ninth Circuit concluded that property must be property of the estate for a trustee to avoid a penalty lien. And it concluded that, once exempted, the residence was no longer property of the estate. "Once the Bankruptcy Court allowed the Debtor's homestead exemption under Arizona law, the Debtor withdrew her exempted property interest from the property of the estate." For the tricky proposition that exemptions can change what is property of the estate, the court cited, among other cases, to *Owen v. Owen*, 500 U.S. 305 (1991) ("[a]n exemption is an interest withdrawn from the estate [and hence from the creditors] for the benefit of the debtor"); and *Gebhart v. Gaughan (In re Gebhart)*, 621 F. 3d 1206, 1210 (9th Cir. 2010).

> Since the Debtor's homestead exemption withdrew the Prescott Property from the estate, the Circuit Court reasoned that section 724(a) was inapplicable here because of its reference to section 726, which in turn applies only to "property of the estate" at the time of distribution. The Circuit Court summarized: "Thus, it is clear from the express language of § 724(a) and its cross-reference to § 726(a)(4), as well as the statutory context provided by §§ 724 and 726, that § 724(a) concerns the trustee's avoidance of qualifying liens attached to the property of the estate at the time of distribution."

The Ninth Circuit observed that the debtor did not escape from the federal tax lien, which was not subject to her exemption, and that she kept her interest in the property subject to that lien. This result avoided the potential for the debtor paying the tax lien twice: if the trustee avoided

the lien and distributed $26,000 of proceeds from a sale to creditors, the debtor would still owe the $26,000 penalty to the government.

7. **Chapter 7 Trustee Can Sell Avoidance Actions, Even if Buyer Does Not Pursue for Benefit of All Creditors: *In re Portland Injury Institute, LLC*, No. OR-21-1138-GTB, 2022 WL 263490 (B.A.P. 9th Cir. 2022) (unpublished).**

The Bankruptcy Code contains provisions that allow a bankruptcy trustee to avoid certain prepetition transfers, using either particular avoiding powers set forth in the Bankruptcy Code (e.g., §§ 547 and 548) as preferences or fraudulent transfers or state law avoiding powers, by stepping into the shoes of a hypothetical judgment creditor or bona fide purchaser for value of real property. These powers are exercised to augment the bankruptcy estate by bringing assets that should be available to pay creditors back into the estate that were transferred out of the estate prior to the bankruptcy filing. The question presented in this case was whether and under what conditions a chapter 7 trustee could sell these avoiding powers to a creditor of the estate.

Portland Injury Institute LLC ("Debtor") was formed by Dr. Do as a single member LLC, to perform chiropractic services. The Debtor entered into an agreement with Platinum Management Inc. ("Platinum") pursuant to which Platinum provided management and other services to the Debtor.

Disputes between the Debtor and Platinum began early in the relationship, including the provisions of the agreement that Platinum contended made its principal Golovan a minority owner with a right to purchase Dr. Do's interest if he left the practice. Because of these disputes, the Debtor informed its patients that it would no longer provide services and ceased operations. Platinum asserted that Dr. Do collected payments and insurance reimbursements on behalf of the Debtor after operations ceased and did not account for over $200,000 of the Debtor's funds.

The Debtor filed a chapter 7 bankruptcy case listing as its only assets office equipment and accounts receivable. The Debtor included Platinum and Mr. Golovan as unsecured creditors, listing their claims at $0. The Debtor also scheduled Mr. Golovan as owner of a 49% interest in Debtor but indicated that the interest was disputed.

The chapter 7 trustee filed a motion to approve the sale of the estate assets to Platinum pursuant to § 363 for $15,000, subject to overbid. The property to be sold included all the Debtor's personal and intangible property and all causes of action against third parties, including the chapter 7 trustee's avoidance powers under the Bankruptcy Code. These avoiding powers specifically included rights "to pursue the debtor's former principal for any avoidable transfers made while that principal controlled the debtor."

Dr. Do objected to the sale on numerous grounds, including that the chapter 7 trustee could not sell the avoidance actions to Platinum unless Platinum was pursuing interests common to all creditors and would exercise those powers for the benefit of the remaining creditors. Platinum argued that Ninth Circuit precedent allowed the chapter 7 trustee to sell avoidance actions "to one who would not exercise the powers for the benefit of all creditors," citing *Duckor Spradling & Metzger v. Baum Trust (In re P.R.T.C., Inc.)*, 177 F.3d 774, 781 (9th Cir. 1999).

The bankruptcy court determined that its role in considering whether to approve a sale was to decide whether the chapter 7 trustee properly exercised its business judgment in reaching the sale agreement. The bankruptcy court found that it could not "remake Trustee's deal and must defer to Trustee's reasonable business judgment." On the sale of the avoidance actions issue, the bankruptcy court followed *Simantob v. Claims Prosecutor, LLC (In re Lahijani)*, 325 B.R. 282, 288 (B.A.P. 9th Cir. 2005), which held that an avoidance action could be sold to a creditor because the purchase price being paid to the estate would benefit all remaining creditors. Dr. Do appealed the order approving the sale to the BAP.

The BAP found in the chapter 7 trustee's favor, holding that Dr. Do's appeal had no merit. The BAP specifically affirmed existing Ninth Circuit law regarding the right of a bankruptcy trustee to sell bankruptcy avoiding powers, citing *Lahijani* and other cases. The BAP also held that the bankruptcy court's obligation in considering a sale motion under § 363(b) "is to assure that optimal value is realized by the estate under the circumstance," and that it should defer to the trustee "where business judgment is entailed in the analysis or where there is no objection," citing *Lahijani*.

On appeal, Dr. Do also argued that the bankruptcy court was required to evaluate the sale under the "fair and equitable" settlement standard in *Goodwin v. Mickey Thompson Entertainment Group (In re Mickey Thompson Entertainment Group)*, 292 B.R. 415 (B.A.P. 9th Cir. 2003). The BAP found that Dr. Do did not raise this argument in the proceedings below, so had waived it. The BAP addressed the issue anyway, and found that, because the potential avoidance actions at issue were against Dr. Do and not Platinum, there was "no basis for the court to analyze the sale of claims against Dr. Do under the

settlement standard when such claims are sold to a third party who is not a potential defendant."

In sum, the BAP rejected Dr. Do's argument that the avoidance actions could be sold only to a third party who would pursue exercise of the avoidance powers for the benefit of all creditors, because the BAP had specifically rejected this argument in *Lahijani.*

8. **Entry of Postpetition Order Validating Lien Did Not Violate the Automatic Stay in Action Brought by Debtor: *In re Censo, LLC*, 638 B.R. 416 (B.A.P. 9th Cir. 2022).**

In *In re Censo, LLC*, the BAP held an that an order entered by a federal district court shortly after the plaintiff debtor had filed a chapter 11 petition did not violate the automatic stay and was thus entitled to preclusive effect.

The BAP found several exceptions that applied to prevent the order from violating the automatic stay under 11 U.S.C. §§ 362(a)(1), (a)(3), (a)(4), or (a)(5). Citing to *City of Chicago, Illinois v. Fulton*, 141 S. Ct. 585 (2021), the BAP found that the postpetition order of the district court: (a) was not an act to create, perfect, or enforce a lien; (b) sought only to maintain the status quo; and (c) was not an act against the debtor. *Censo* is currently on appeal to the Ninth Circuit as Case No. 21-1125.

The owner of a condominium unit was behind in the payment of assessments imposed by the homeowners' association. The unit was subject to a deed of trust. The HOA conducted a foreclosure sale. After foreclosure, the foreclosed homeowner sued the purchaser in federal district court, along with the HOA, the secured creditor, and others, seeking to invalidate the foreclosure. The foreclosure purchaser filed an answer, counterclaims, and crossclaims, contending that the HOA's foreclosure had extinguished the deed of trust.

The secured creditor then filed a motion for summary judgment, seeking a declaration that the purchaser bought the unit at foreclosure subject to the deed of trust. The motion was under submission in the district court when the purchaser filed a chapter 11 petition, and shortly thereafter the district court issued its ruling that the deed of trust was valid. Meanwhile, the purchaser-debtor filed an adversary complaint in bankruptcy court alleging defects with the deed of trust. The bankruptcy judge granted a motion to dismiss the lawsuit based on issue preclusion.

The debtor appealed, alleging that the district court order validating the deed of trust was void because it had violated the stay, and thus was not entitled to any preclusive effect.

The BAP considered each of the potential grounds for violation of the stay in § 362(a), beginning with the "commencement and continuation" of actions under subsection (a)(1). The BAP said this subsection "applies only to actions **against the debtor**." [Emphasis in original]. The BAP found that in this case, the debtor began the fight by aiming to invalidate the mortgage. "Under any common sense interpretation," the mortgagee's counterclaims and summary judgment motion were defenses to the debtor's claims, and thus the order by the district court did not violate § 362(a)(1), even though it disposed of the mortgagee's counterclaims against the debtor. The BAP noted that under Federal Rule of Civil Procedure rule 8(c)(2) it did not matter that the motion for summary judgment sought to resolve counterclaims rather than an affirmative defense, because the district court had authority to treat the counterclaim as an affirmative defense "if justice require[d]."

Next, the BAP looked at § 362(a)(3), which precludes taking possession of property of the estate. The court cited to the Supreme Court for the proposition that "[a]cts that simply maintain the *status quo* do not violate the automatic stay." City of Chicago v. Fulton, 141 S. Ct. 585, 590 (2021). The BAP noted that the mortgage existed on the filing date and that the order of the district court "simply affirmed the validity of the existing lien. It did not affect [the debtor's] possession or control of the Property," and thus the order did not violate § 362(a)(3).

Finally, the BAP found no violation of § 362(a)(4) and (a)(5), because the order did not "create, perfect or enforce" a lien. The BAP upheld the bankruptcy court's dismissal of the debtor's complaint because the district court's order did not violate the automatic stay and supplied the elements of claim preclusion.

The BAP supported its analysis by finding that "none of the policy reasons for § 362(a)'s stay of litigation against a debtor" were "implicated" by the order, as it "did not diminish the estate" or "unfairly benefit one creditor over another."

Note that in general, if there is any doubt, creditors should inform the nonbankruptcy court about the defendant's bankruptcy filing. *See e.g.* Stuart v. City of Scottsdale (*In re* Stuart), 632 B.R. 531 (B.A.P. 9th Cir. Nov. 10, 2021).

9. Increase in United States Trustee's Quarterly Fees Is an Unconstitutional Violation of Bankruptcy Uniformity Clause: *Siegel v. Fitzgerald*, 596 U.S. ___, 142 S. Ct. 1770, 213 L. Ed. 2d 39 (2022).

Article I, Section 8, Clause 4 of the U.S. Constitution grants Congress the power to establish uniform laws on the subject of bankruptcy. This case deals with a non-uniform law enacted by Congress regarding quarterly fees in chapter 11 cases. Under 28 U.S.C. § 1930(a)(6)(A), chapter 11 debtors must pay quarterly fees to the United States Trustee ("UST") until the case is converted or dismissed. The amount of the fee depends on the total amount disbursed in the bankruptcy case each quarter. Prior to an amendment to the fee schedule, the quarterly fee ranged from $325 per quarter, for cases where disbursements total less than $15,000, to a maximum of $30,000 per quarter, for cases where disbursements total more than $30,000,000.

In 2017, Congress enacted a temporary increase in the fee rates applicable to large chapter 11 cases to address a shortfall in the UST Fund ("2017 Amendment"). The 2017 Amendment provided that if the balance in the UST Fund as of September 30, 2017 were less than $200,000,000, the fee raise would become effective in the first quarter of 2018, would last only through 2022, and would be applicable to currently pending and newly filed cases. Under the 2017 Amendment, the new quarterly fee schedule provided that if quarterly disbursements by a chapter 11 debtor equal or exceed $1,000,000, the quarterly fee would be the lesser of 1 percent of such disbursements and $250,000.

On September 30, 2017, the balance of funds in the UST Fund was below the minimum threshold. As a result, starting January 1, 2018, two months after the 2017 Amendment was codified, the UST started collecting fees based on the 2017 Amendment in chapter 11 cases pending on that date and in cases filed thereafter.

In all states besides Alabama and North Carolina, bankruptcy cases are overseen by the UST Program, which is a part of the U.S. Department of Justice. In six federal judicial districts in Alabama and North Carolina, bankruptcy cases are overseen by the Bankruptcy Administrator Program (BA Program), which is managed by the federal judicial branch. Unlike the UST Program, the BA Program districts did not charge quarterly fees early in their existence. In response to a Ninth Circuit decision that it would be unconstitutional for the UST Program to charge quarterly fees when the BA Program did not, in 2000 Congress enacted 28 U.S.C. § 1930(a)(7), which allows the Judicial Conference of the United States to require a chapter 11 debtor to pay quarterly fees equal to those imposed under the UST Program under the BA Program.

In 2001, the Judicial Conference issued a standing order directing BA Program districts to charge the same fees as those imposed by the UST Program. However, after Congress codified the 2017 Amendment, the six BA Program districts did not implement the new fee schedule until September 2018, when the Judicial Conference ordered the BA Program districts to implement the new fee structure.

Unlike the UST Program, which imposed the new fees on all cases pending on or filed after January 1, 2018, the Judicial Council ordered the new fees to be charged in "cases filed on or after" October 1, 2018. This created a gap period during which the fees charged in certain chapter 11 cases pending in the BA Program judicial districts were significantly lower than those in the UST Program districts.

In 2020, after a few courts held that the 2017 Amendment violated the Bankruptcy Clause's uniformity requirement, Congress amended § 1930(a)(7) to replace the permissive "may" with "shall," ensuring that all fees charged in the UST Program and BA districts were the same going forward. The amendment was signed into law in January 2021, with legislative findings that the 2020 amendment was intended to "confirm the longstanding intention of Congress that quarterly fee requirements remain consistent across all Federal judicial districts."

In 2008, Circuit City Stores, Inc. (the "Debtor") filed chapter 11 in the Eastern District of Virginia, which is administered by the UST Program. In 2010, the court confirmed a liquidating plan (the "Plan") to be overseen by liquidating trustee Alfred H. Siegel (the "Trustee"). Under the Plan, the Trustee was required to pay the UST quarterly fees until that case was closed or converted. When the Plan was confirmed, the maximum quarterly fee was $30,000.

The Circuit City case was pending when the UST Program started to collect fees based on the 2017 Amendment. In the first three quarters of 2018, the Trustee paid $632,542 in total fees, rather than the $56,400 that would have been owed before the 2017 Amendment.

The Trustee challenged the increased fees in the bankruptcy court, arguing that the higher fees were not applied uniformly across UST Program and BA Program districts and were therefore unconstitutional. The bankruptcy court agreed, holding that the Trustee would only be required to pay the pre-2017 Amendment fees, because the 2017 Amendment was unconstitutional. The court reserved the question whether the Trustee was

entitled to receive a refund of the overpayments made in 2018.

On a direct appeal to the Fourth Circuit Court of Appeals, a divided panel reversed. Noting that the uniformity requirement "forbids only arbitrary regional differences in the provisions of the Bankruptcy Code," the court of appeals concluded that Congress did not draw arbitrary distinctions between debtors and creditors based on their places of residence. Rather, Congress codified the 2017 Amendment to solve the UST Program's funding shortage, which was not a problem in the BA Program districts.

The Trustee filed a petition for writ of certiorari with the Supreme Court, which was granted to resolve a split in the lower courts as to the constitutionality of the 2017 Amendment.

In a unanimous decision by Justice Sotomayor, the Supreme Court reversed the Fourth Circuit and held that the 2017 Amendment violated the Constitution's bankruptcy uniformity clause. In arguing that the uniformity clause was not implicated, the UST had contended that the 2017 Amendment fee provision is not a law "on the subject of Bankruptcy" and did not alter the substance of the debtor-creditor relationship. The Court rejected that argument, noting that the uniformity clause does not distinguish between substantive and administrative laws. The Court further noted that the term "laws on the subject of Bankruptcies" is broad and includes "nothing less than the 'subject of the relations between [a] debtor and his creditors.'" The Court further noted that all courts that had considered this issue, including those that found the 2017 Amendment constitutional, agreed that the uniformity clause applied to the 2017 Amendment.

The Court next considered whether the 2017 Amendment complied with the bankruptcy uniformity clause. The Court acknowledged that Congress has flexibility to address geographical differences through different laws applied to the different regions, but the Court found that Congress could not do so through "arbitrary geographically disparate treatment of debtors." Justice Sotomayor reviewed the three cases where the Court had previously considered the uniformity requirement. In two of the cases, Congress had addressed unique, isolated problems that arose in specific regions of the country but not in the entire country. In the third case, the Court had struck down legislation that singled out a debtor and did not apply to other similarly situated debtors in bankruptcy proceedings.

Since the 2017 Amendment was not geographically uniform, the Court examined whether the different treatment was based on a permissible purpose. The Court rejected the argument that the disparities were intended to solve a specific geographical problem, namely the funding shortfalls experienced by the UST Program. The Court found that the shortfalls were self-imposed by Congress, which arbitrarily separated the UST Program and BA Program districts and funded them using "an artificial funding distinction that Congress itself created."

The Court specifically did not address whether the dual system involving the UST Program and BA Program districts was unconstitutional. The Court also noted that Congress may enact laws that treat classes of debtors differently or that respond to geographically isolated challenges without violating the uniformity clause. As of the date of this writing (prior to publication), the Second Circuit Court of Appeals has held that debtors who were charged the increased quarterly fees are entitled to a refund. Clinton Nurseries of Md., Inc. v. Harrington (*In re* Clinton Nurseries, Inc.), No. 20-1209, 2022 U.S. App. LEXIS 32677 (2d Cir. Nov. 10, 2022).

10. **Debtor May Use Higher Homestead Exemption Amount in Effect on the Petition Date to Avoid Lien, Notwithstanding Contrary State Law: *Barclay v. Boskoski*, 52 F.4th 1172 (9th Cir. Nov. 14, 2022).**

This case addresses one effect of the major increase in the California homestead amounts, and allows a bankruptcy debtor to use the higher exemption to avoid seasoned judgment liens. Under California Code of Civil Procedure ("CCP") section 703.050(a), "the amount of an exemption shall be made by application of the exemption statutes in effect . . . at the time the judgment creditor's lien on the property was created." In this case, the Ninth Circuit held that, notwithstanding state law, the Bankruptcy Code allowed the debtor to avoid the lien under § 522(f) as impairing the debtor's exemption based on the amount of the exemption at the time of the bankruptcy filing.

In 2014, the judgment creditor recorded an abstract of judgment and thus obtained a judgment lien in excess of $200,000 against the debtor's residence in Carlsbad, California. In 2014, the then-applicable California homestead exemption to this debtor was $100,000.

In August 2021, the debtor filed a chapter 13 bankruptcy petition, later converted to chapter 7, and claimed a $600,000 homestead exemption. California is an "opt-out state," (CCP section 703.010(a), 703.130), which generally means that bankruptcy debtors in California use the exemptions provided by state law that are in effect at the time the petition is filed. Effective as of January 1, 2021, California amended the homestead exemption to be the greater of: (1) the "median sale price for a single family

home" in the debtor's county the year before the debtor claims the exemption, "not to exceed" $600,000; and (2) $300,000. *See* CCP § 704.730(a) (2021).

The residence was worth about $1.1 million. The debtor made a motion to avoid the judgment lien under 11 U.S.C. § 522(f)(2)(A), which allows the debtor to avoid judicial liens "to the extent they impair an exemption to which the debtor would have been entitled under subsection (b)." The residence was subject to deeds of trust in excess of $550,000, and, using a $600,000 homestead exemption, there was no "equity" in excess of the homestead for the judgment lien to attach to.

The trustee objected to the debtor's motion on the ground that the applicable homestead exemption under state law was $100,000 (the amount of the exemption when the lien was created); thus, there was about $400,000 in "equity" that the judgment lien attached to, and the "avoidable" portion of the lien was about $45,000.

The bankruptcy court granted the debtor's motion to avoid the entire judgment lien, and certified a direct appeal to the Ninth Circuit, and the Ninth Circuit affirmed.

The decision relied on the precedent of *Owen v. Owen*, 500 U.S. 505 (1991), which includes language to the effect that section 522(f) measures impairment, not by the amount of the exemption to which the debtor "is entitled," but by the amount to which the debtor "would have been entitled" were it not for the judgment lien. In the absence of the judgment lien, the debtor was entitled to the current higher homestead amount, and the judgment was subject to avoidance in full.

The trustee argued that the outcome should instead be governed by *Wolfe v. Jacobson (In re Jacobson)*, 676 F.3d 1193 (9th Cir. 2012) (holding that California state law, which required that proceeds from the sale of a homestead had to be re-invested in a new residence within six months of the sale to retain their exempt character, applied to bankruptcy debtors). Rejecting this argument, the Ninth Circuit held in *Boskoski*:

> It is true that, in *In re Jacobsen*, we held that . . . 'it is the entire state law applicable on the filing date that is determinative of whether an exemption applies.' . . . But Owen tells us that the Bankruptcy Code's policy of permitting state- exemptions is not "absolute." 500 U.S. at 313. Instead, it must be applied "along with whatever other competing or limiting policies the [Bankruptcy Code] contains."

Thus, the debtor was able to use the current expanded California homestead exemption and enjoy the benefits of over $500,000 in equity in their residence, free of any judgment lien.

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